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COMMENT AND OPINION

Running with a Pack

MR. V. W. T. Scully, Deputy Minister of National Revenue for Taxation, in his recent address to the Institute of Chartered Accountants of Ontario, made a statement, the purport of which has long been in our minds for comment in these pages. We have awaited an opportunity to express ourselves in this matter and here are our thoughts.

The statement is "The Department examines with the greatest care returns supported by financial statements prepared by accountants whose clients have already come under suspicion" (see page 155 in this issue).

Mr. Scully was, presumably, most careful to leave no inference that these accountants are under suspicion, but we wish to dwell on that possibility in this note. Those of us who have growing children know that they are conditioned to a considerable extent by their friends and we try to ensure that they stay in what we consider to be good company. We all know that every dog in a pack comes under suspicion when the pack runs wild and causes injury to persons or animals or damage to property. The prestige and reputation of grown people depend to a large extent on the company they keep and the character of those with whom they are constantly in close contact.

Individuals permitting themselves to "run with a pack" which is under suspicion for any reason will invariably find that some part of the suspicion held against the others will be held against them. That this applies to accountants is particularly evident when the practice of a public accountant is found to consist largely of clients engaged in the same type of enterprise and having common objectives and similar problems. It must be in such a case that either the group of clients exerts influence over the accountant or that the accountant exerts influence over the group. If the group comes under suspicion, the accountant is bound to be looked at askance.

The greatest effort, for their own good, should be made by all public accountants to keep their practices diversified. Independence is the all-important criterion of the trusted public accountant. How can such independence be taken for granted or, if need be, demonstrated, if the bulk of one's clientele is found to be a group closely connected and with a common purpose?

This common purpose may not be an illegal one under close definitions of appropriate statutes; it may be merely one which is repugnant to a substantial number of thinking people. To cite but one example outside the accounting field, there is nothing illegal about "ambulance chasing"; yet we have heard, perhaps only by way of gossip, of members of several professions who, by a

course of action resulting in their coming constantly to the notice of thinking people, give the impression that they are "ambulance chasers". Their reputation is not thereby enhanced, although temporarily their pocket-books may be in excellent order.

Specialization is all right to a degree, but it has hazards which are well worth being kept constantly in mind.

Tacit Connivance

A NUMBER of our members have taken the view that Mr. Scully's words which immediately followed the phrase quoted in the previous comment are unfair to public accountants generally. It may be that one's recollection of what has been said is not altogether precise and leads to inferences which were not intended. For our part, we feel that no serious objection can be taken. If we are wrong, we should be most interested to learn of more than a few cases of deliberate fraud in which it can be shown that a reasonably vigilant auditor would not have his suspicions. The complaint is that these suspicions were not followed up. Here are the words (they will be found in their proper context on page 155),—

> To you representing a wide range of taxpayers, I should say that few cases of deliberate fraud can be carried out effectively without at least the tacit connivance of the taxpayer's auditors. This is a grievous reflection on the profession. Fortunately, it has a narrow application. I suggest that all of you should be eternally vigilant. Fraud is fraud and is none the less reprehensible because the public purse is the one that is being robbed. I believe that an accountant has an important duty to his profession and his community, as well as to his client. The Department's efforts in this phase of its work are worthy of full support.

Possibly the sentence "This is a grievous reflection on the profession" is a little strong. We wonder if the peccadilloes of a few members of the staff of the Department would be considered by Mr. Scully as a "grievous reflection" on the Department. We do not think he would admit that in a serious vein. They certainly are reflections, but are to be expected under any law of averages.

The Department itself helps not at all in assisting the profession generally to deal with its few cases. Presumably, a "deliberate fraud" would result in a prosecution. In that case, it should be easy to set up in the Court proceedings the "tacit connivance" of the auditor, thereby giving the profession's disciplinary committees something to work on. The professions are as anxious as the Department is to keep their own houses clean.

Administration Of Income Tax

By V. W. T. Scully, O.B.E., F.C.A.
(*Deputy Minister of National Revenue for Taxation*)

The organization of the Taxation Division of the Department of National Revenue

IN MY VIEW, the professional accountant can play his great role in national affairs only if his objectives include,—

1. The attainment of high skill in the science of accounting;
2. Scrupulous observance of the rules and ethics of the profession;
3. Personal integrity above and beyond the reach of calumny or slander.

These are objectives not easy to attain, but easy to lose sight of in the swiftly moving tide of modern practice. High standards of skill and conduct are, in my opinion, so important that without them we as a profession have nothing. It is very fortunate for Canada and for us Canadians who have taken up accounting as a profession that those men who built the provincial Institutes of Chartered Accountants never lost sight of these aims and never permitted their weaker associates to forget them.

High standards are important to the Department of National Revenue because it employs more professional accountants than any other organization in Canada (there are 240 chartered accountants in the Division as well as a large number of members of other well-known and highly regarded associations of accountants), and because the work of the Division, to a large extent, is influenced by the skill and integrity of those who advise the public on their tax problems.

During recent years — especially since the war — working conditions in the Division have improved to such an extent that ambitious, able and vigorous young men can look forward with certainty to worthwhile and honourable careers in the Division. I should add that it is becoming extremely difficult to get in. Standards are being maintained at high levels and even those who can qualify, but who are looking for soft jobs, easy hours or merely security, had best look elsewhere.

Organization

First, there is the Minister. He is the head of the Department, elected to Parliament by the democratic system and required by that system to answer to Parliament for everything his Department does. While he is certainly the political head of National Revenue, he is also deeply and actively concerned in the administration work. In this regard, he is in constant touch with his senior officials

An address to the Institute of Chartered Accountants of Ontario, Toronto, March 2, 1950

and expects to be and is consulted on all policy matters and all administrative decisions of consequence. Incidentally, it is the custom in this country for many people to write directly to the Minister about their tax problems and many of these letters require and get the Minister's personal attention.

It is part of my duty [as Deputy Minister for Taxation] to see that the Minister is kept fully informed of what the Division is doing. Generally, this is accomplished by formal reporting but more usefully, in some ways, by frequent consultations which include, as the occasion warrants, the senior and technical officers who are associated with me.

Next, I suppose I should include my own office which consists of myself and my secretary. The Assistant Deputy Minister, Mr. Gavsie, is a lawyer. As you may gather, Mr. Gavsie and I work closely together. While a very considerable amount of work and responsibility has been delegated to other officials at head office and the district offices, there is enough left to keep us going without much respite. The measure of this will be clearer to you if you will remember that in addition to directing the work of the whole Department (which includes considering all the major staff, organization and technical problems that arise in a large Department) much time must be given to the public and their advisers. I endeavour to be available at all times to see the taxpayer who feels that I personally should consider his particular case. It is a time-consuming task but one that cannot be delegated satisfactorily.

On this matter, I would suggest to those of you who are active in the tax field that appointments with me or other head office officials can be made more easily and effectively through the local district offices. Much time can be saved for all of us if this method is followed.

The main body of the Division divides into two principal groups:

(a) The Tax Group — consisting of the assessing, succession duty, special investigation and legal branches;
(b) The Administration Group.

The head office subdivisions, except for the Legal Branch, are roughly followed in the district offices.

The Tax Group

The Tax Group is relatively small in numbers but contains a preponderance of highly qualified legal and accounting people.

At present, the Department is carrying out a programme of consolidating its assessing units in order that better service can be rendered to the public. An important result of this will be a more economical and efficient use of professionally-trained men and women. To some extent, these are dispersed at present by a somewhat illogical division of work among what are widely known as the T.1, T.2 and succession duty branches.

The Administration Group

Approximately two-thirds of the whole staff are in the administration field. Here, there are three main subdivisions:

i. Inspection;
ii. Personnel;
iii. Administrative Services.

Inspection is the branch that is constantly examining into the activities of all units of the Division, probing and scrutinizing, not so much as internal auditors but as the eyes and ears of the Deputy Minister. It brings to light waste, duplications, departures from prescribed methods, etc. and, what is equally important, it keeps the Deputy Minister in close touch with the widely scattered activities of the Division throughout the country.

The personnel branch recruits, selects,

promotes, demotes. In fact, this is the unit which keeps the Department alive. Up to a very short time ago, the Taxation Division was the orphan of the public service. It was created as a temporary Department during the first war and was not in fact a part of the Civil Service. This has now been changed, I am happy to say. Not only does the change add to the prestige of the staff but it does insure to them all the benefits and advantages available to the Civil Service — the most important of which is appointment and promotion by the competitive system. The full effects of this radical change are not yet apparent. I mention it because it marks an important milestone in the progress of the Division.

The administrative services group is the Division's largest. Here are accounting, collections, statistics, forms, tax-roll, files, accommodation, and all the other multitudinous jobs that modern society seems to require of its servants.

To illustrate, I will take the tax-roll. In effect, here is where the Division begins. The tax-roll is the list of all persons and corporations who are or might be or should be taxpayers. It is compiled from information returns, directories and other sources. Recently, the tax-roll operation was combined with the filing. This combined unit is now known internally as tax-roll files. Substantial economy and greater efficiency have been effected by the consolidation. The Department has approximately 3,850,000 active files and approximately 4,725,000 names on the tax-roll. These operations, of course, are conducted in the district offices.

Another most important job that falls to the administrative services group is the accounting-collection operation. Until quite recently, accounting, collections and cashiers were three separate units. They are now being combined into one. This again results in economy and efficiency. The Department has approximately 567,500 open accounts. The number varies during the fiscal year, rising steeply in the first six months when the new assessments are going out and falling in the second half as the collection operation speeds up. Since the inception of income tax, some 33 years ago, accounts deemed to be uncollectible amount to some $6,944,710, less than .0543% of the total amount collected. A very considerable part of the cost of operating the Division is attributable to delinquent taxpayers who represent a small part of the total in numbers and in amounts of taxes. Since most of you are taxpayers, you should realize that you bear this cost. I find it discouraging at times to learn of professional accountants advising clients to delay tax payments or to arrange their affairs so that taxes are not paid until the Department takes action. That a substantial part of these taxes has to be spent to ensure their collection does not seem to be generally understood. It is difficult for the Department to reduce its costs if the taxpayer who pays them does not give his co-operation.

Assessing

As I mentioned earlier, the Department is combining into one branch all assessing activities. Two prime purposes lie behind this —

1. To achieve complete uniformity of practice;
2. To deploy trained people so that their skills can be applied to the best advantage of all concerned.

The separation into corporation, individual, succession duty and special investigation branches tended to freeze good assessors in one or other field, thereby limiting their training and experience.

As many know, the Division fell far behind in its work during the war. The loss of irreplaceable people, the acute

shortage of trained accountants, combined with the growing complexities of tax legislation, made it impossible to cope with the work. I am glad to say that by the end of March, assessments will have been completed for all years and all taxpayers to the end of 1948. Annually hereafter each year's work will be done each year. In fact, the Division has already processed many thousands of 1949 returns. This is quite an accomplishment and one that the staffs in all the offices throughout Canada should be proud of. Your servants in the Taxation Division have laboured prodigiously and well. It is my hope that never again will it be necessary to face such a task.

Appeals

Inherent in this progress is the disposal of appeals. The creation of the Income Tax Appeal Board has greatly increased the number of appeals. Within the Department has been created an appeal section — wholly independent of the assessing branches — to handle appeals. Here too there was a very large backlog of work. Contrary, perhaps, to popular conception, the greatest care is exercised in disposing of appeals. There is, of course, the closest co-operation between the legal and accounting staffs. The more difficult problems are widely discussed before a conclusion is arrived at. Most appeals are resolved to the mutual satisfaction of the Department and the taxpayer. Those which are not are invariably considered by the Assistant Deputy Minister or myself before a decision is issued. I should add here, I think, that the Department does not want to collect one cent of tax which is not properly exigible. But I should also mention that it is no longer possible for a taxpayer to defer payment of a tax liability by entering an appeal. I commend this point especially to those who appeal on frivolous grounds with the intention of deferring the inevitable.

So far, I have kept away from quotations from the Statutes and comments on tax policy. I should like to add a few remarks which at least impinge on those fields.

Pre-eminence of the Law

The legal and accounting professions played an important part in the development of the *Income Tax Act*. It is, of its kind, a good law — better perhaps than that of any other country in the world. From the administrative standpoint, the fundamental difference between it and the *Income War Tax Act* is the disappearance of substantially all the discretionary powers of the Minister. This great change has simplified the work of the officials. Whether this is good or not is not for me to say. But tax consultants, whether they are lawyers or accountants, should remember that under the *Income Tax Act* the law governs. Whatever one may feel as to the equities, there can be no deals and no privileges. A clear understanding of this should greatly facilitate the work of the consultant — and of the Department.

Perhaps the best illustration of what I mean can be found in the capital cost allowances. There has been criticism of the new sections and of the regulations. That is as it should be; but bear in mind that the apparent complexities of what is now the law arise not so much from the changes of methods as from the fact that what was heretofore an informal arrangement between the taxpayer and the Department now must be spelled out in black and white for *all* taxpayers. Every contingency must be considered. As far as it is humanly possible, the draftsmen must cross each "*t*" and dot each "*i*". The result looks complex. For the vast majority of taxpayers, it is not. For those with schemes of one sort or another in mind, it may be. The Department believes that, given fair trial, the taxpayer

will find the new practice simple, broad and generally advantageous.

Section 9(6)

There has been some highly speculative comment regarding the application of section 9(6). As you know, this section has existed in one form or another for many years, but has not been invoked until recently.

The Department, as I told you, has been reaching a current position in its work. This means, in addition to other things, that it now becomes possible to look at many aspects of the work prospectively. The improvement of administration is always under active consideration especially in the realm of tax avoidance. Section 9(6) and other little-used provisions of the law were enacted to be applied. Future policy in that regard is now being developed.

It has been stated that the business man knows best what funds he should retain in his business. With that view the Department has no serious difference of opinion. Action under section 9(6) has been taken only in those cases where the Department had definite knowledge that an arrangement was in the making which would remove substantial surpluses from the business and, at the same time, from the reach of taxation.

Tax Evasion

This leads to my last point — a brief word about tax evasion. There are in general two types of tax evasion,—

1. Deliberate fraud;
2. What our lawyer friends would call the exercise of a taxpayer's legal right to pay as little as he can arrange to pay — within the law.

With deliberate fraud, I venture to say, no reasonable person has any sympathy. In addition to examination by the assessors, the Department is able to apply the special investigation or intelligence unit to uncovering these cases. There has been a fair amount of success but this will be much better now that investigators of experience and ability have been trained to uncover the tax-dodgers. That these dodgers will be caught is practically inevitable. Most of them would be well advised to make their peace with the Department while there is still a chance to avoid the full consequences of criminal prosecution.

The Department receives, studies and co-ordinates quantities of information from many sources. It is considered of first importance to sift all data that might uncover fraud. Some interesting discoveries are made. For example, in one important case, the disclosure came from an examination of export forms B.13. Uncertified financial statements always attract special attention and, of course, the Department examines with the greatest care returns supported by financial statements prepared by accountants whose clients have already come under suspicion.

To you representing a wide range of taxpayers, I should say that few cases of deliberate fraud can be carried out effectively without at least the tacit connivance of the taxpayer's auditors. This is a grievous reflection on the profession. Fortunately, it has a narrow application. I suggest that all of you should be eternally vigilant. Fraud is fraud and is none the less reprehensible because the public purse is the one that is being robbed. I believe that an accountant has an important duty to his profession and his community, as well as to his client. The Department's efforts in this phase of its work are worthy of full support.

In the second type of tax evasion or avoidance, there are much more subtle techniques. So long as there are loopholes in the law, there will be escapes from taxes. There can be no great quarrel with the legality of that even if one may question the morality of it. The

administration tries to be fair across the board. It is an ideal perhaps beyond attainment. Thousands of dollars are spent annually in this country ostensibly to minimize taxes. I wonder if it ever occurs to people that tax avoidance is to a large extent merely the movement of the burden to other shoulders. It is the Department's function to administer tax legislation, not to make it, and therefore, to the fullest extent, the provisions of the Act will be invoked to ensure the most equitable administration possible.

A Plea for Help

In conclusion I would like to make a plea for help. It is a serious matter for any member of the Department's staff to accept gifts or favours from taxpayers or their representatives. The practice of ingratiation became quite prevalent and is now being stamped out. Any person who induces a member of the staff to disregard his duty will render such member a great disservice because he will certainly be fired promptly and the person himself will bring himself into serious disrepute with the Department.

And lastly, I should like to say that the Department welcomes criticism — if it is serious and constructive. So long as there are taxes, there must be machinery to collect them. The Canadian system has a tradition of honest and fair administration. I believe all people, but especially professional accountants, have a responsibility to see that that type of administration continues.

The Accountant In the Welfare State

By Douglas D. Irwin, B.A., C.A.

Social welfare measures and increasing Government supervision and controls are subtly changing the role of the accountant

A GREAT deal of thought is being given in professional and business circles to the problems which have been raised by the controls exercised by Government upon economic activity.

The Omnipresent State

Since the turn of the century, and at an accelerated pace during the past 15 or 20 years, Government has been assuming an ever expanding authority over the lives of men and in particular over the policies and practices of commercial enterprise. The majority of the citizens in almost every nation have been demanding and receiving increasing measures of protection against the slings of fortune. Sometimes the demand, if latent, has been elicited by political platforms based on the premise that the economic welfare of all should be the responsibility of all. The legal recognition of collective bargaining, the strengthening of labour codes, the provision for workmen's compensation, unemployment insurance, old age pensions, family allowances, the development of central banking and use of the graduated income tax have all been instituted with a view to establishing a floor under the standard of living below which the least able will not be permitted to fall. Security has become the watchword of politics and the touchstone of policy.

In appeasing this demand and in some respects fostering it, Government has been obliged to expand its budget and to meet the requirements of social welfare with ever higher taxes and a closer supervision over the level and temperature of business activity. The measures which this control involves have been formed into a significant philosophy with principles and logic, its end being the creation of the welfare state and its means a mechanism of economic checks and balances designed to produce an essentially stable economy without depriving it of forward motion.

This trend in economic and social thinking has not been confined to Government alone. In many countries Government has taken the initiative but even in our own country and particularly in the United States there is a strong and conscious movement by business itself to provide the securities demanded by the rank-and-file employees through self-imposed plans for pensions, group insurance, and sickness and accident benefits. Provision for security in these forms has also found increasing popularity with management for its own protection. Revision in income tax laws

with liberal allowances for pension contributions, and easement in the taxation of lump sum retirement payments both show that business with the aid of Government is itself contributing to the creation of the welfare society.

Whatever may be our private opinions of these developments it seem inevitable that we live now in a world in which the motivation is toward a welfare state. It seems doubtful if the process can be reversed: it may be decelerated, but it is unlikely to be stopped altogether.

Impact on the Accountant

In the face of these great changes the public accountant has been called upon to increase his knowledge and to widen his range of service. As the confidant of the business man in planning his activities in such a way that he may achieve maximum efficiency within limitations imposed by the new developments, the public accountant may consider it worthwhile to review his position and take stock of his new opportunities.

Is the function of the public accountant likely to change as we approach the achievement of the welfare state? What is the place of the accountant in the welfare state? The answer to these questions may be found in principle by replying to a further question. What has been the function of the public accountant in any state?

The history of accounting is almost coincident with that of recorded history. Some form of accounting is usually found among the earliest of historical documents and it is an interesting commentary on the place of our profession that the earliest forms of account-keeping were connected with the operations of Government. The collection of taxes and the expenditure of public funds created the necessity both for the accountant and the auditor. The principles and techniques of both branches of the profession have been developed and improved throughout history to a very large extent as a direct result of the expansion in the authority and control of Government. Eventually the citizen also sought out the services of the public accountant and in due course our profession emerged in its modern form as a kind of commercial tribunal upon whose impartial judgment and rigid honesty both business and Government have come to rely as a necessary agency in the conduct of the nation's affairs. It follows, therefore, that with the increase in the machinery of government inherent in the welfare state the public accountant will occupy an increasingly important position as the interpreter and mediator between the state and the individual.

A review of accountancy today indicates that the emphasis on the various services of which the profession is capable has materially altered during the past 50 years.

In the days when business was a one-man affair and Government was a lenient referee the rules of the game were somewhat spontaneous. The business man felt himself capable of running his own affairs with little or no outside advice or assistance. In that era the public accountant was expected to perform little more than the function of auditor and his advice on other matters, if sought, was often given reluctantly and with qualifications. However, as the scope of business has widened it has become increasingly difficult for one man to hold within his power, let alone his head, all the ramifications of economic and social change and legislative enactments which affect the operation of his enterprise. We have, therefore, observed the development of the fields of investment banking, industrial engineering, and business consultation as separate and independent professions.

In an effort to meet the new needs and

to supply the demands of business upon him the public accountant has been obliged to acquire knowledge and experience in these new fields and in many respects to practise his ancient art with a wider conception of his responsibilities.

There is no hint in this suggestion that the standard of conduct or the principles of auditing and accounting should be changed in their basic concept but rather that they be applied with greater vision in order to adapt the role of the profession to present day conditions.

New Responsibilities

New questions of responsibility are posed. Is the public accountant of today giving his client all the service of which he is capable if he restricts his analysis to the computations involved in the preparation of a set of financial statements? Is the auditor in that capacity of the public accountant discharging his duty if he confines his investigation to the correctness and honesty of the company's operations as shown by its books?

Of course, if asked to do so, the public accountant will undertake to investigate and report upon many aspects of business policy not falling directly within the limits of his original engagement, but, notwithstanding, the suggestion is herein made that we should assume the privilege of reporting upon matters outside the essential details of an audit report which may be of vital interest to the enterprise. This does not imply that such reporting should be a substitute for the standard auditor's report but should be additional to it or be an entirely separate report dealing with matters affecting the present and future position of the client which may not easily be presented in or revealed by financial statements. The shareholders of banks, trust and insurance companies are given such vital information through the annual reports of managers and directors but the smaller corporations are for the most part deprived of this form of interpreting current economic trends in terms of their own enterprise. If this need is to be satisfied, the public accountant appears best qualified to provide this comprehensive advisory service to business on all phases of economic activity.

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Indeed almost imperceptibly we are accepting this change of role. To a large extent the work of senior accountants is now more concerned with the analysis of future operations in corporate finance than with past operations. Advice with respect to the incidence of taxation, the inauguration of pension schemes and improvements in system occupy a large part of the public accountant's time. Furthermore in many minor and sometimes major ways the accountant is expanding into the field of industrial management. It is to be hoped that the profession will encourage this latter development as a proper function of our general service.

All these changes in emphasis are real manifestations of the needs created by the controls, taxes and government economic policies which are part of the machinery of the welfare state. The mechanics of planning have indeed imposed on the public accountant new and to a large extent untried responsibilities.

Education for the New Needs

If the accountant of tomorrow is to be thrust even more forcibly into these new fields, then his outlook and training must be designed to meet them. Courses of instruction leading to degrees in account-

ancy in the future will certainly include material of a wider nature than would have been conceived useful 50 or even 20 years ago. Besides having a grasp of the basic principles of accounting and auditing, the qualified public accountant must have fundamental knowledge of corporate finance, economics, the use and methods of statistical calculation, actuarial science, and the principles of law. In addition he should have advanced training and an almost literary facility in the use of English, a capacity for analysis and synthesis, and the ability to present the results of such methods of investigation in clear and comprehensible terms. Finally the standards of the profession should require an understanding of sociology and political economy, and of the citizen's duties and responsibilities.

Ethics and Morality

These new needs and requirements also raise ethical and moral considerations. For as we go beyond strictly accounting matters and attempt to interpret law and regulation as they impinge upon business activity we automatically assume a greater responsibility to the public at large. We may find ourselves giving advice or condoning practices which, though they may be of immediate advantage to the client, in the long run may be contrary to public good and, therefore, indirectly harmful to the client himself. As government regulations become more important in the day-to-day decisions of business, of which the public accountant has knowledge, this unhappy dilemma may become increasingly awkward. Our advice and recommendations in the aggregate will have a more and more far-reaching effect on the economy as a whole and we must therefore be on guard to ensure that the profession acts with the impartiality and honesty which are its distinctive features.

This attitude would be of particular advantage to clients themselves for as we are now enjoying the privilege of a democratic and articulate electorate we may assume with certainty that Government will be forced to respond with appropriate action wherever and whenever business is found wanting in its conduct. We should then be acting in the long term interest of the profession and of the client if we give advice which will protect his business from reproach. To this end it might be useful for all professional accountants to impose upon themselves something in the nature of a Hippocratic oath and all student accountants should be impressed repeatedly with the high professional standards expected of them.

New Fields of Practice

Apart from all of these general considerations the development of the socially-minded state has opened up several new specific and intensely interesting fields in which our profession is or ought to be finding expression.

One of the most neglected of these new opportunities is that of accounting and auditing on behalf of labour unions. Unions are here to stay and collective bargaining has become one of the necessary mechanisms in the conduct of industrial enterprise. In its approach to management, labour leadership is now taking care to be informed by the best legal and economic advice in order that the expectations of labour (though sometimes exceeded by the demands) may be nicely computed to secure the maximum gains in wages and benefits without crippling an industry. This calls for analysis of corporate operations and the effect of increased wages and benefits upon the future of the enterprise. As yet in these major developments in labour-management relations the public accountant has not fulfilled his proper function. This oversight may properly be attributed to the failure of the public accounting pro-

fession to recognize in the rise of unions a significant new field.

The funds collected and expended by unions in themselves have become too large to be neglected any longer. If the profession does not assume responsibility for and seek out these clients we may find that Government will be forced to order a satisfaction of the need for public accounting of the funds.

As members of a profession we must consider it our duty and our right to serve all clients without bias. Just as the doctor diagnoses and prescribes for the body without considering the beliefs or personality of the patient, so we must interpret economic data for labour union clients with the same degree of impartiality that we extend to commercial enterprises. In so offering our services equally to labour and to management we could do much to allay the inherent suspicion between these two giants in the economy. It is conceivable that labour unions, if properly and fairly informed of the financial condition of an industry and advised honestly as to the effect of increased benefits upon the level of employment, would reduce their demands and thereby prevent strikes. Conversely a detached opinion, given to management, that a particular wage increase or benefit was economically feasible and even desirable might also promote industrial peace. But until we have gained labour's confidence that we can and will act with this degree of professional integrity for both sides we may be the unwitting cause of continued discord between labour and management.

Publicly-owned Enterprises

One of the most important phases of the planned economy is that of the growth of publicly-owned enterprises. Public utility accounting is a branch of the science developed to a large extent in the twentieth century. The special considerations and principles involved in its requirements call for an almost completely new conception of such matters as asset valuation, depreciation, replacement costs and income calculation. The degree of astuteness and insight on the part of the accountant in applying these new concepts may have important effects on the general public through the calculations and principles which are involved in rate-setting.

In meeting the new requirements of public utilities and government regulation thereof, the accountant has been obliged to develop special techniques and to widen his range of service. Without this professional service the operation of public utilities would be reduced to haphazard guess-work. Thus, once again the expansion of government participation in and control of certain branches of industry have made new demands upon and increased the responsibility of our profession.

The Accountant in Government

The development of the welfare economy has also beckoned the accountant to the wide fields of government itself and the subsidiary machinery involved in economic control. It is a fundamental fact in life that all activity must eventually be recorded in terms of the monetary unit. Every new scheme conceived by business or government must be finally assessed in the light of cost and the effect of the incidence of such costs upon the economic structure. Engineers and economists are entitled and expected to conceive and draft the plans but in some form or another the accountant must eventually review them and pass upon the details of their operation. Government agencies in this country, the United States and Great Britain have recognized to an increasing degree, in recent years, the fitness and ability of persons trained in public accounting to execute and con-

trol the multifarious operations involved in economic planning. Public service, therefore, has made ever greater demands for trained accountants and is now a serious competitor for the annual crop of graduates. This circumstance is highly complimentary to the profession and to the standards of work and ability which it represents.

Growing Need for Accountants

The public need for professional accountants may be expected to increase rather than to diminish as government control expands. There will always be the need for a professional body whose outlook is conservative and critical. If he stands for anything the professional accountant should stand for unhurried judgment and, above all, for truth. His code must always be based on rigid honesty and his opinion must ever be soundly established on fact. With these principles his profession will be just as valuable in a planned socialist state as it has been in a system of *laissez-faire*. If he is known and respected for these qualities he may contribute much to preserving the rights of the individual from the advance of totalitarian authority of either Fascist or Communist origin. On the other hand democratic government will find his rectitude a strong staff on which to lean in its unsteady advance into the realms of planning. For the government of a nation may range from a policy of pure competition to one of state monopoly as in Communism, but it must have its facts honestly and fearlessly presented. Any government, democratic or otherwise, which is falsely informed will surely collapse. How very important then is the role of the professional accountant in preserving the right to freedom of thought and action by ensuring that business and government does not fall prey to self-deception. The need for his professional role will always exist. His standards of conduct and the principles of our science will be universal and enduring.

Spokesmen for the Public

There remains one more important area in which the services of the accounting profession should be in greater demand. If lawyers have been recognized as the chief instigators of public policy, accountants are becoming to an increasing degree the executors of those policies. As government activity expands to large proportions, the manner of execution and interpretation of the law may be as important as, if not more important than, the letter in which the law was conceived. We have already exercised great influence in the matter of interpreting income tax law. Moreover through such organizations as The Canadian Tax Foundation public accountants have attempted to influence the law with a view to avoiding ultimate inconveniences, omissions and difficulties in the law as finally passed. It seems that with this increasing awareness of public responsibility it follows as a natural step that the accountant should consider it his duty to shed his cloak of anonymity and step into the limelight of public affairs thereby helping to make the law.

There is no other professional training which requires such a varied and fundamental knowledge of practical every day affairs as that demanded in public accountancy. The professional accountant may not be an expert economist, tax authority, solicitor, or industrial engineer but he must have some experience in and knowledge of all these fields. In addition his practical science of accounting, his familiarity with corporate finance, banking and the effects of business policy upon employer and employee cause him to be one of the most obvious and best qualified representatives of his fellow citizens in a democratic society.

Internal Control And Internal Auditing

By T. Reginald Cloake, C.P.A.

The effect of internal control on the audit programme

THERE have been numerous definitions propounded for "internal control" and since it is not the purpose of this discussion to arrive at the perfect definition, if one could be obtained, it will suffice to describe it generally as a form of procedure within an organization which offers a method of checks and balances to the extent of discouraging theft, promoting accuracy and reliability of the accounting data, and developing general operational efficiency. To the extent that such control accomplishes these ends, it follows that the necessary review by the independent auditor is lessened. His certain "musts" in auditing (as, for example, confirmation of bank balances, examination of securities, confirmation of accounts receivable, etc.) cannot be eliminated, but the extent of his tests may be minimized, especially insofar as they concern operations. In fact the existence of a substantial degree of internal control is what makes possible the successful conclusion of independent audits of very large concerns. The accounting regulations of the United States Securities and Exchange Commission explain this point:

> In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

The role played by the internal auditor in maintaining control procedures will be discussed in a subsequent paragraph.

Evaluating Effectiveness of Internal Control

In evaluating the extent of internal control some public accounting firms employ questionnaires several pages in length. In such instances it is concluded that the questionnaire form is so inclusive that where all questions appearing therein are answered satisfactorily, the system of control is complete. Other firms do not use specific questionnaires but have the system of control evaluated by the senior accountant during the course of his examination. Should he observe laxity in con-

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trol, or shortcomings in procedures, he will note completely the shortcomings and will not specifically write up the procedures for control where they do exist. The danger in the use of the questionnaire alone, without continued observance during the course of the audit, is that practices, although answered in the affirmative in the questionnaire as the result of questioning the concern's employees, may be entirely different in actual operation. In any event, the evaluation of an internal control system should be done by an experienced and well trained accountant. It should not be delegated to assistants.

The Internal Auditor in Internal Control

The place of the internal auditor and his staff in the development and maintenance of internal control is of especial importance. In fact the internal auditor is an integral part of the entire internal control system. A special report entitled "Internal Control", issued this year by the Committee on Auditing Procedure of the American Institute of Accountants, includes the following on the internal auditor's function:

> An internal audit staff may be used not only as a check on the accuracy of the accounting data and the safeguarding of the company's assets, but also as an instrument of management in determining adherence to prescribed policies. Thus, the audit activities should be widespread, covering all departments.

Adherence to prescribed policies refers to the maintenance of procedures which in themselves are a part of internal control. The report continues:

> The review and appraisal to be useful to management must be unbiased — free from any departmental influence as to the scope of the audit programme and the method of reporting thereon. The internal auditor should be free to advise management of any deficiencies noted, without fear of reprisal from any department heads. His relationship to the department head should be clearly set forth by management to avoid any misunderstanding as to their relative positions. Under such conditions the internal auditor is in a position, without any limitations, to serve management in the detection of frauds, weaknesses in procedures and in the clarification of policies on a company-wide basis.
>
> In many instances, while the size of the organization may warrant segregation of the internal audit function, the economic employment of personnel of the quality compatible with complete independence may not be practicable. Under such conditions the question often arises as to the propriety of incorporating the internal audit function into the sphere of the controller. An arrangement of this sort is generally regarded as satisfactory, assuming independence of the accounting and auditing function at the next lower level.

This emphasizes the need for independence in review and the maintenance of greater than arm's length relationships with other employees. The fact that the internal auditor and department head both serve the same concern makes it difficult to make uninfluenced criticisms. Lunching together, attending parties together, etc., further contributes to non-independence. However, it is not impossible for the internal auditor to maintain a constructive, impartial and critical attitude. Educating executive and administrative employees as to the benefits of constructive reviews of their departments as an aid to the promotion of efficiency does help. Rotation of internal auditors, the assignment of auditors to other than their home plants, and other techniques are employed to promote maximum independence.

Independent Auditor's Reliance upon Internal Auditor's Review

After concerns have gone to great length to establish and maintain internal auditing departments, some complain that the independent public accountants do not give full recognition to their reviews, do not adjust their programmes accordingly, and do not avail themselves of their compiled information. There is something to be said on both sides of this question. The Institute of Internal Auditors, Inc., New York City Chapter, in a recent news bulletin stated the position of the internal auditor as determined from a questionnaire sent to its membership:

> Perhaps the most disappointing replies received were those relating to the interrelationship between public accountants and internal auditors. There are many leading firms and individuals in the field of public accounting who still either do not or will not recognize the role of internal auditing.
>
> The question was asked: "Does a close working relationship exist between your company's internal auditor and its public accountant?" One hundred and five companies answered this question, and of these 22 answered in the negative. This failure is believed to be due largely to a lack of understanding of modern internal auditing on the part of men in the public accounting profession. The Institute of Internal Auditors should take active steps to correct this situation.

Perhaps public accountants should take the initiative. The bulletin continues:

> This question was asked: "In the opinion of your company's public accountant, could he issue an unqualified certificate if the company did no internal auditing?" The direct answers were divided almost 50-50 between certified public accountants who said they could issue an unqualified certificate and those who said they couldn't if there was no internal auditing in a given company. Does this mean that the certified public accountants answering in the affirmative do more work than is really necessary in companies having internal auditing staffs? Or, and this appears more likely, does it mean that these certified public accountants fail to understand just what work is performed by the internal auditors? Internal auditing is an essential factor in internal control in any large or complex company, and if this function is not performed, the certificate ought to be qualified to reveal the fact that the system of internal check and control is not complete.

As previously stated, the existence of internal auditing and other procedures for internal control makes possible the audit of very large concerns, and enables an unqualified certificate to financial statements to be issued.

Cooperation

Coordination and cooperation between the independent auditor and the internal auditor are much to be desired. They are born of an appreciation of each other's functions and a cooperative spirit in the solving of respective problems. In order that the independent auditor may place the maximum reliance upon the effectiveness of the reviews made by the internal auditor, the internal auditor's programme of audit should be developed in close cooperation with the independent auditor, giving the latter an opportunity to criticize constructively where he believes reviews are inadequate or procedures lacking. The internal auditor's pro-

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gramme, when once established and used, should be maintained as a permanent record, including in it the dates when specific reviews were performed and the initials of the internal auditor who did the reviewing. The internal auditor's reports and working papers should be offered to the independent auditor for his information or use. Where the independent auditor suggests the elimination of duplication of effort by having the internal auditor prepare analysis of accounts or other data for his use, then appropriate carbon copies should be prepared for him. If special forms of analysis are desired then these should be laid out in cooperation so that, although serving different purposes, the working papers may be of maximum use to both.

Some independent auditors might be criticized for maintaining a haughty, indifferent and superior attitude; fortunately such individuals are in the minority. Such attitudes are entirely unjustified and personal, they are not representative of the certified public accounting profession, but reflect only the shortcomings of the individual auditor.

A lack of understanding between the internal and independent auditor may arise because the internal auditor does not appreciate that the independent auditor has certain "musts" in his programme, as mentioned before. The internal auditor's attitude may be such that he resents the independent verification of something which he knows is correct. On occasion the independent auditor will refuse to rely upon the internal control effected by the internal auditor where he learns that the internal auditor's time has been utilized to a great extent by the accounting department in special studies, systems work, preparation of statements, etc. Sidetracking of the internal auditor to other than his principal function is often likely to occur. This is especially so because the internal auditor is usually a highly skilled accounting technician who can help out in special accounting problems. In smaller concerns with less well organized internal auditing departments, the internal auditor might find that he spends so much time doing special jobs for the treasurer that he has little time for internal auditing.

Conclusion

Let us not lose sight of the goal in any auditing procedure, the completion of the review and the appropriate presentation of findings in a manner that is economical, expeditious, accurate, and complete. We, as independent accountants, cannot do less than certain required minimum of independent audit, but we must recognize internal controls where effective and adjust our programmes accordingly. The exercise of mature judgment is required in determining the extent of examination and whether the interests of stockholders and creditors justify the time and expense involved in pursuing any particular line of independent inquiry.

Because fullest cooperation is not always existent, it behooves both internal and independent auditors to subject themselves to self-analysis and criticism and to mend their ways if they find shortcomings. Auditors are professionally concerned with the criticism of others, yet, being human, they will have difficulty in making unbiased criticisms of themselves.

Sick Companies

By L. N. Buzzell, C.A.

The chartered accountant as a doctor of business

A SAGE who lived in quieter times than these once defined business as being a matter of "tilling the mind and minding the till". He wasn't far wrong, and chartered accountants spend the best part of their lives trying to make business do both of these things.

A chartered accountant is, in effect, a doctor of business and, like a doctor of medicine, he must learn when his patient needs a shot in the arm, an operation, or a salutary dose of castor oil. Business, being the creation of humans, can inherit the characteristics of its creators. In treating sick businesses, the trick, of course, is to know not only when to prescribe but precisely what to prescribe.

Unfortunately, shareholders, directors, management, bankers and creditors occasionally find themselves involved with a sick company. The problem here is to restore the patient to health and keep him healthy. If he is to be nursed along, all interested parties must satisfy themselves that he is not mortally ill and headed for the grave-yard called the bankruptcy court.

What Makes Companies Sick?

To begin with, it would be well to answer the question — what makes companies sick?

There are many causes, including the following main ones —

1. A great number of people responsible for the management of businesses have not the administrative capacity to conduct their affairs properly.
2. History teaches us that periodic depressions occur which wreck many enterprises, very much as a gale sweeps through a forest, blowing down the weak and diseased trees.
3. Many companies try to conduct their affairs with inadequate capital or with an unsound capital structure which will not withstand the "slings and arrows of outrageous fortune" to which a business, like individuals, is subject.
4. Overproduction in some particular industry may lead to a collapse of inventory values.
5. Unsound dividend and salary policies may rob a company of its reserves and make it vulnerable to the vagaries of fortune of the business world.

It is sad, but true, that the owners of too many concerns view them, not as enterprises that should be carefully nurtured for the benefit of themselves, the employees and the public at large, but as something to be plundered for the

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benefit of a few selfish and greedy individuals.

6. Technological developments may deprive a business of its position in the market, through its inability to meet the lower costs achieved by competitors with modern machinery, engineering techniques, etc.
7. There may be changes in tariff and foreign exchange regulations which may destroy a company's market and its sources of raw materials.
8. Deterioration of products due to lack of supervision or a desire to earn unduly large profits temporarily, at the cost of the firm's reputation.
9. Bad labour relations, which demoralize the productivity of an enterprise and render it incapable of successfully continuing operations.
10. Bad public relations, which give rise to a feeling among consumers that the company and its products are not to be trusted.
11. Internal strife between different shareholder, employee and management factions, which saps the "punching" ability of an enterprise.

Symptoms

There are a number of storm signals which indicate to an expert that a company is on the down-grade. These include declining earnings, "gilding the lily" by charging inadequate reserves for depreciation, bad debts, etc., overvaluing inventories, a weakened working capital position and a deterioration of the products. These signs of trouble will almost invariably lead to the best employees leaving to take other jobs, a general decline in morale, and a lack of confidence on the part of the bankers and other creditors and shareholders.

When conditions become serious, it is customary for boards of directors, bankers, creditors or management to call in the professional accountant to give advice on the causes of this unsatisfactory state of affairs and to present a solution. Under these circumstances, what steps must the accountant take to shoulder the great responsibility placed upon him?

If the company in question happens to be a client, the accountant (unless he has been remiss in his duty as auditor) should be in possession of the facts which are causing the decline. If not, he must take steps to acquaint himself with them and make his report accordingly. The questions he will be expected to answer include —

(a) Is the management sound?
(b) Has the company any prospects?
(c) Can it pull through?
(d) Should it be liquidated?

Investigation of Causes

My experience in these matters has taught me that the accountant must adopt the following course of action —

(*1*) Secure the confidence of the management and obtain their views both as to what is wrong and what corrective measures appear necessary. If they are honest, they will nearly always give their advice freely, as they are usually very worried and glad to share the responsibility of action with someone else appointed by individuals who are critical of their efforts and who have lost confidence in them. An important function of the accountant is to help restore this confidence, if necessary, but he must not be misled by any false optimism on the part of individuals who wish him to make a favourable report.

(*2*) Prepare comparative balance sheets and statements of surplus account and earnings for the past 15 or 20 years, or for the life of the company if it be a lesser period, and note carefully the fluctuation of operating ratios, decline of sales, and so on (having regard to general economic conditions). These figures are revealing and often enable the accountant to put his finger on weaknesses which the management either have overlooked or are incompetent to overcome.

(3) Make a careful analysis of the last balance sheet, or, if necessary, prepare one, to ascertain whether the assets are overvalued or whether any liabilities have been understated.

(4) Study the cost system (if any) to make sure that erroneous costing has not led the company either to sell some of its products under cost or to attempt to sell others with an unduly large margin of profit.

(5) Study the credit policy to ensure that in an effort to force sales the company has not been extending unwise credit.

(6) Make a careful study of any affiliates or subsidiaries which may be drawing off the company's resources, through either bad judgment or dishonest manipulation by directors or others.

(7) Study the labour policies and wage systems in force. These may well reveal bad labour relations, unsound piece rates or incentive plans, or even padding of the payroll.

(8) Study the system of inventory control to make sure that no pilferage exists, that the inventory is not obsolete, and that materials are being properly charged into production.

(9) Review the basis of allocating factory and general overhead to ensure that the cost of the product includes these elements and that they are properly distributed.

(10) Study sales markets to see whether any are being maintained or developed where there is no possibility of profit, due to adverse transportation costs or keen competition.

Report

When the accountant is in possession of all the above facts he will be familiar with the good and bad points of the business and will be able to report on the best course, in his judgment, to be adopted. The general scope of his report should include —

(i) A complete report on every item in the balance sheet, giving the basis of valuation and his opinion as to the validity of such valuation. This may involve securing other professional opinions, such as engineering reports on the plant properties, inventories, etc.

(ii) A thorough *résumé* of the comparative operating figures under review, with comments on unfavourable or favourable operating ratios. Here it is invaluable to have access to statistics of similar types of businesses, which can often be obtained from trade associations, government bureaus or research departments of universities.

(iii) A report on unsound dividend policies, depreciation charges, and the activities of any subsidiary or affiliated companies.

(iv) Comments on labour relations and policies.

(v) Comments on the condition of the books and records, and recommendations as to their improvement.

(vi) Comments on the company's products, markets, etc.

(vii) Comments on the capacity of the management and recommendations as to whether it should continue or be changed.

(viii) Recommendations that a "Three-way Budget System" be installed to reveal —

(a) The anticipated monthly profits or losses for the next 12 months.

(b) The anticipated monthly surplus or deficiency of cash receipts for the next 12 months.

(c) The estimated monthly balance sheet position for the next 12 months.

These statements will answer the questions which are invariably asked —

1. Can the company make money?
2. How much will be required to finance it?
3. How will such money be paid back, and what is the security for advances made or to be made?

The management will almost always state that the peculiar nature of the particular business makes it impossible to

forecast with any degree of accuracy the operating results for the next 12 months. Their objections, however, can usually be overcome by pointing out that the past 12 months' figures can be used as a guide, that they have the right to "guess safe", and that, in any case, such estimated statements must be drawn up in order to obtain the credit necessary to carry on. It is extraordinary how the prospect of a bank loan stimulates the imagination. The preparation of a budget of this kind is of the greatest importance, as it compels the management to constantly examine the policies and expenses with minute care. It nearly always leads to constructive changes which enhance the company's chances of operating on a profitable basis. Many is the line of credit I have seen granted on such a budget, and it is astonishing to see the results that can often be accomplished. The installation of a budget system can frequently save a company from bankruptcy by restoring its credit and placing the management "on its toes" to achieve the anticipated results. Once this system is installed, management will seldom again be without such a "rudder".

(ix) Recommendations as to information for monthly submission to management, directors, bankers and other interested parties. This usually includes the preparation, before the 15th of the month, of —

(a) A balance sheet as at the end of the previous month, compared with the estimated balance sheet.

(b) Statement of operations for the previous month and cumulative since the beginning of the period, compared with the estimated statement.

(c) A report stating why certain objectives provided in the budget have not been met.

When a report along the above lines has been completed it will form a comprehensive guide as to the present position of the company, its prospects and the steps necessary to place it on a sound basis. Unless the examination discloses gross irregularities or incompetence, it is desirable to give present management a chance, under close supervision, to rehabilitate the company.

However, the duties of the accountant are not completed when he has prepared his report. He will frequently be asked to recommend a comptroller to assist with the preparation of the budget and to closely supervise the finances. He will be expected to attend meetings of the directors and with the company's bankers, and even to sit on the board of directors. He will be required to supervise the preparation of the monthly statements and discuss them with all the interested parties. It is only thus that everyone will be satisfied that all proper steps are being taken to rehabilitate the affairs of the business.

Some Cardinal Principles

There are certain cardinal principles to be observed in working out the affairs of a sick company. These include —

1. Display a real and personal interest in the affairs of the business and never let it become just "another case".
2. Obtain the confidence of the management and their assistance in preparing the original survey. Review this report with them before submitting it to bankers or directors.
3. If possible, always have the management present when the report and the company's affairs are discussed with directors and other interested parties. It is always well that those responsible for the company's affairs concur in any conclusions and recommendations arrived at. The accountant must always remain an impartial referee; should he depart from this role, he will lose the confidence of all parties.
4. If it is decided that the business is to continue, insist that recommendations be carried out, particularly those in regard

to the preparation of a budget and monthly statements.

It will be readily appreciated that this type of work carries the accountant far afield from his usual duties as auditor. It is of an administrative nature, and the accountant must share the responsibility of management. His reputation will stand or fall by his success in finding the formula to place ailing companies on a sound basis. He will not always succeed, but he should make every effort before recommending bankruptcy proceedings. Bankruptcy is like litigation — everybody loses.

This type of work is arduous and nerve-wracking, the responsibility is great, the hours are long, but there is a tremendous satisfaction in seeing a "sick baby" restored to health and everybody happy. The reward of the accountant (in addition to his fee) is not only to gain a client but to make real friends. There is nothing that will enhance his reputation like success in a few of these "salvage" jobs.

Failure and Liquidation

If all efforts fail to save a business, it must be liquidated. When bankruptcy proceedings are found to be inevitable, a host of new questions and problems present themselves, such as —

1. Is it possible to rehabilitate the affairs of the company by recourse to *The Companies' Creditors Arrangement Act*, which Act provides that a majority of the creditors can grant a company relief without formal bankruptcy proceedings?
2. If it is necessary to place the company in bankruptcy, should its operations be continued or its assets liquidated for the benefit of the creditors?

The problems of a trustee in liquidating or reorganizing the affairs of a company are legion and include such decisions as —

1. Who are to be appointed inspectors to assist and advise the trustee?
2. What privileges have creditors for "30-day goods"?
3. Are creditors claiming a privilege entitled to rank as privileged?
4. Is the security claimed by secured creditors valid?
5. Should the assets be sold by auction or private sale?

The trustee frequently finds himself the target for criticism from all parties, and he must suffer such criticism and treat all classes of creditors fairly and in accordance with their respective rights.

As in the case of dealing with sick companies, here again the accountant will stand or fall by the integrity and business acumen he displays in dealing with bankruptcy situations.

The accountant cannot escape his obligation to do this type of work. The business community is looking more and more to him to develop an organization to take command of difficult situations. I am afraid that the profession as a whole has not in the past lived up to its duty in this respect. Until we do, we shall continue to see incompetent "specialists" doing a great deal of bad work in a field in which we should be the recognized experts.

In conclusion, I would like to suggest that experience in dealing with sick companies and bankruptcy matters, when coupled with a sound auditing training, is indispensable to the complete all-round education of a chartered accountant, whether he remain in the profession or accept an executive position in the business world.

Depreciation

By C. A. Ashley, B.Com., F.C.A.

A Socratic contribution to the historical cost-replacement cost controversy

PROFESSOR Canning, in his *Economics of Accountancy,* must have been one of the first to attempt to relate the two subjects of his title; he also deplored the "astonishing lack of discussion of the nature of income" by accountants, who "have found almost nothing to say about the nature of the thing they measure so carefully".

Confused Thinking

An American psychologist has defined intelligence as that quality that is tested by intelligence tests (thus earning our gratitude by throwing light on psychologists at any rate). The accountant might with greater reason say that income is that which is measured by an income and expenditure account, but he would not be defining income. If he thought about it a little more he might say that by the use of various techniques and conventions he arrived at a figure which was useful to the business world and which was generally known as income. The difficulty that accountants experience with definitions is illustrated by an item in *Accounting Concepts of Profit* (Gilman). In the index of this book we find "Capital — meaning of, 4." On page 4 we find the following: "Accounting can be greatly misunderstood by those who are unfamiliar with accounting terminology. Such words and phrases as 'current assets', 'net worth', 'surplus', 'value', 'capital', 'revenue', 'fund', and 'reserve' are commonly employed by accountants, to whom their meanings usually are clear. Laymen, however, sometimes fail to understand those meanings and as a result may be led into confused thinking". An economist who is anxious for exact definitions may be excused for believing that the confused thinking is not entirely amongst the laymen.

After a very long struggle, accountants established a high degree of uniformity in their thinking on depreciation, and to a large extent had persuaded the business world to go with them. Professor Paton (*Essentials of Accounting*) says, "There is also a very common tendency — from which even accountants are not exempt — to confuse depreciation accounting and financing of replacements . . . As a matter of fact depreciation represents the extreme example of prepayment." Professor Finney (*General Accounting*) says, "This expiration of invested costs is called "depreciation". As far as Canada is concerned this is not a case of the academic accountant rushing off into an expression of impractical idealism; very

few Canadian accountants were likely to confuse depreciation and replacement, they were prepared to accept the words of the American Institute Accounting Research Bulletin No. 22, " . . . a system of accounting which aims to distribute the cost or other basic value of tangible capital assets . . . over the estimated useful life . . . in a systematic and rational manner. It is a process of allocation, not of valuation."

Until recently, the difficulty accountants had with businessmen was in persuading them that depreciation was a charge which had to be recorded irrespective of and before the determination of profits. After the *Companies Act* made the statement of depreciation charges for each year obligatory, this point became of less importance. The influence of the income tax administration made the accountant's position more difficult, and during poor times more and more auditors' reports made specific reference to depreciation.

The Problem of Rising Costs

In recent times a new problem has become important. In a period of rising costs, replacements are costly and businessmen look around to see if any relief is in sight. Instead of treating this as a matter primarily of business policy, an attempt has been made to join it up with depreciation. This is partly due, no doubt, to the hope that larger charges for depreciation might be allowed for taxation purposes; it is also partly due to the old confusion between depreciation and replacements that had not been completely removed from the mind of the businessman. The danger arises of the scrapping of a great deal of excellent work done by accountants in making accounting statements rational and comprehensible. Even if we do not believe in accounting principles we may object to a change in well established accounting practices for the purpose of solving a problem by changing something which is not directly related to the problem. We may also deplore any break in the ranks of the accountants.

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The Journal of Accountancy, January 1950 gives a report of an address given by Professor Paton on "Measuring Profits under Inflation Conditions". Without giving any definition of "profits", he says "there is substantial justification for the view that corporation profits — the amount of the earnings of stockholders — have been materially overstated in recent years". In the absence of any definition, all we can say is that profits have been determined more and more in accordance with Professor Paton's earlier writings, and that we had thought this an excellent thing. Now, he is apparently prepared to abandon his old position without making his new one very clear: " . . . the great bulk of American plant was acquired some years ago . . . this element of our plant is grossly understated in terms of current costs and dollars, and the depreciation charges based thereon are likewise understated". But we do not now know what he means by "depreciation". He quotes with approval an English writer: ". . . these concerns have been showing comfortable

profits, paying profit taxes thereon and distributing dividends; but it is now revealed that they are not earning sufficient profits to meet even partial plant replacement costs and that for years they have, in effect, been paying dividends from capital".

The Need for Definition

This shows up the danger of trying to get along without definitions. What is said in this last quotation carries with it strange implications. Suppose a company makes regular profits (measured by established accounting methods) and pays out most of them in dividends. If the price level remains about the same everything is all right, but if the price level suddenly rises before the replacement of a piece of equipment is due, then the company has been paying dividends out of capital! The position will become hopeless if we cannot determine the profits of a business for any year until we know what the price level will be in five, ten or twenty years' time.

The provision of funds for replacements is a matter of business policy quite unconnected with annual charges for depreciation. If additional capital has to be raised for the purpose, what could be more natural? Why should an old established business be allowed to carry on indefinitely with the same dollar capital, making higher and higher charges for depreciation and being allowed more and more in taxation, while an entirely new company could carry on a competitive business only by raising a larger dollar capital? If half of the funds are provided by bonds and half by shares, the incongruity becomes even more striking. The Council of the Institute in England and Wales has this to say about it: "Depreciation should be calculated on the basis of historical cost. Those responsible for management should bear in mind in their financial policy the necessity of conserving the finances of the enterprise so that sufficient capital shall be available either by setting aside profits for that purpose or by raising further capital to ensure the future of the business."

Recommendations on the Income Tax Act

Submitted to the Minister of Finance by the Taxation Section of the Canadian Bar Association and the Legislation Committee of the Dominion Association of Chartered Accountants

I. Capital Cost Allowances

For purposes of taxation the new method of providing allowances in respect of capital cost appears to have been well designed, with some exceptions, to provide fair treatment to taxpayers. For accounting purposes, however, the diminishing balance method of providing for depreciation in comparatively few instances is considered to be appropriate and, if the introduction of that method for taxation purposes has the effect of causing taxpayers to abandon proven methods of depreciation accounting hitherto adopted consistently for purposes of determining profits for the information of shareholders and proprietors, then the law and the regulations issued thereunder are objectionable and should be repealed.

1. Reg. 1100(4)

One of the effects of this subsec. is to force companies to abandon sound depreciation accounting and to accord to certain transactions treatment which is at variance with generally accepted accounting procedures. If, therefore, this subsec. is to remain in the regulations, it is our unqualified opinion that the law governing allowances in respect of capital cost should be repealed in its entirety. The subsec. in question reads as follows:

> "Where the taxpayer is a corporation, the aggregate of the allowances under subsec. (1) or (2) shall not exceed the amount deducted in respect of such allowances in computing the income or profit for the taxation year shown on the financial statements presented to the shareholders or members."

At first sight this subsec. appears merely to limit the amount of depreciation allowable to corporations for tax purposes in any year to the amount shown as a deduction in determining income of that year in the financial statements, and to go little further than the previous limitation of depreciation to the amount recorded in the books of account. However, the change to the diminishing ballance method, the provision for recapture under certain circumstances and the allowance for obsolescence inherent in the *Income Tax Act* and the regulations issued thereunder introduce new complications. In operation, subsec. (4) will force one group of taxpayers, namely limited companies, to make a choice between either violating sound accounting procedures or depriving themselves of the right to allowances which the regulations are designed to give to them. It is no misstatement of fact to say that only a company that adopts unsound accounting practices will be in a position to take full advantage of the allowances granted under the regulations.

The implications of subsec. (4) which give rise to this extremely serious situation are not apparent at first sight and can best be illustrated by means of examples, some of which are given below:

(i) *Companies providing for depreciation in their accounts on a basis other than by means of capital cost allowance under the Income Tax Act*

For most companies the provision for depreciation by means of the diminishing balance method is inappropriate and is not a sound accounting procedure. However, to the extent that the provision made in the accounts, regardless of the method adopted, exceeds in any year the amount allowable under the regulations, capital cost is not recoverable as an allowance for tax purposes un-

less or until all assets of the class have been disposed of, a situation which will normally only arise when a company ceases business operations.

(ii) *Mining Companies*

Mining companies are granted a three year exemption from income tax on their mining profits. While as a result of the exemption it is not to the company's benefit to claim depreciation for income tax purposes in these first three years, generally accepted accounting principles require that consistent depreciation provisions be made in the accounts even in this period of exemption. Having done so the appropriate tax allowance can only be obtained when the mine is abandoned.

(iii) *Losses on Disposals*

Where any property is disposed of by a company at less than its net book value sound accounting principles require that this loss be recognized in the accounts and written off immediately. While the general pattern of depreciation regulations permits this loss to be amortized over future years, the effect of subsec. (4) is that no deduction in respect of the loss can be obtained in any year subsequent to the write-off, except when the company has disposed of all assets of the same class. In most cases this will mean that the deduction can never be obtained until the company ceases operating and disposes of its entire plant.

(iv) *Repairs and Improvements*

There are many cases where differences of opinion arise between the taxpayer and the taxation authorities as to the character of disbursements. In the past where the taxpayer has followed a conservative practice in distinguishing between repairs and improvements the taxation authorities have frequently disallowed the expense, but permitted its amortization over a short period of years by way of depreciation, without, however, requiring a change in the actual accounting practice of the taxpayer. Under the new regulations it would seem that the right to deductions for the residual part of such expenditures must be postponed until the class of assets concerned has been disposed of unless the taxpayer is satisfied to abandon its consistent practice by reinstating on its books the undepreciated portion of the expenditure.

(v) *Patents*

Many taxpayers have followed the practice of writing off immediately intangible assets, such as patents. The practice under the *Income War Tax Act* permitted the cost of these patents to be written off over their life despite the fact that they had been written off in the books at an earlier date. The new regulations would seem only to give a partial deduction in the year of write-off, in such cases, and no subsequent write-off of the balance until the year when the patent expires.

(vi) *Appraisal Write-downs*

A number of taxpayers have from time to time written off substantial portions of the cost of major assets as a result of appraisals which indicated that the cost had been excessive. Notwithstanding such write-downs the Income Tax Division has in the past permitted the actual cost to be depreciated on an orderly basis from year to year. Under the new regulations it would seem that in such cases no depreciation on the portion of cost written off can be obtained for taxation purposes until the taxpayer has disposed of all property of that class — presumably when the company winds up.

For years the accounting profession throughout the world has been striving to develop sound accounting practices which will present business operations in the fairest manner possible. That a tax regulation should be the instrument whereby much of the progress al-

ready made in Canada should be nullified is surely contrary to the public interest. Yet, if subsec. (4) is to remain in the regulations, such will inevitably be the result.

It is paradoxical that a measure which was supposed to "mean a great improvement over the old system and . . . . a further step towards greater simplicity in our system of taxing business profits", and which would "likewise be more equitable to the taxpayer and to the treasury" should in fact, because of the inclusion of s. 1100(4), produce precisely the opposite results for all incorporated taxpayers.

RECOMMENDATION: That subsec. (4) of reg. 1100 be deleted.

2. Provision for Recapture (s. 20(1))

Section 20(1) provides for the recapture of allowances in respect of capital cost previously claimed for tax purposes if, upon disposition of property of a prescribed class, the proceeds of disposition exceed the "undepreciated cost to the taxpayer as of *the beginning of the year* of depreciable property of that class". By relating the calculation of the amount recaptured to the undepreciated cost at the beginning of the year, the section will subject to tax an amount in respect of which no capital cost allowance had been previously claimed. Where a taxpayer purchases property of a class during the year and subsequently in the same year disposes of it, the excess of the proceeds over the undepreciated capital cost of the property of that class as at the beginning of the year is regarded as income.

RECOMMENDATION: That the section be reworded to relate the calculation of the amount recaptured to the undepreciated capital cost at the end of the year in which disposition takes place.

3. Unincorporated Taxpayers — Computation of Tax on Recapture (s. 20(1))

Section 20(1) will in some circumstances deny to taxpayers a full allowance for loss in respect of capital cost actually sustained. In the case of the unincorporated taxpayer, any recapture which is to be regarded as income by reason of this section will be subject to tax at the highest rates applicable to that taxpayer for that year. It may well be that the rates applicable to the allowances in respect of capital cost previously claimed by the taxpayer, even though at his highest rate in each case, are significantly lower than the rates applicable upon the amount of the recapture, and he will thus be denied a certain portion of the allowance to which he is entitled if he is not to bear a tax on capital.

RECOMMENDATION: That the unincorporated taxpayer be given the option of computing the tax upon the amount of the recapture as if the amount had been recaptured in equal portions over a five year period.

4. Losses Not Always Recoverable (s. 20(1))

Under some circumstances s. 20(1) and reg. 1100(3) will have the effect of denying to taxpayers their full allowance in respect of the capital cost of depreciable property. If a taxpayer has disposed of all the property of a class during the year, reg. 1100(3) provides that what would otherwise be the undepreciated capital cost of the property at the end of the year will be allowed as a deduction in that year. If the income of the current year and the preceding year is not sufficient to cover the loss and if the taxpayer is ceasing operations, there is no manner by which the tax already paid on this loss can be recovered.

RECOMMENDATION: That taxpayers be given the option of spreading the loss over the previous 5 years possibly restricting this option in the case of incorporated taxpayers to those companies going out of business.

5. Scrapping or Abandoning Depreciable Property (s. 20(3)(b))

Section 20(3)(b) defines "disposition of property" as including any transaction or event entitling a taxpayer to proceeds of disposition. Where property is scrapped or abandoned, there are no proceeds therefrom. Reg. 1100(3) provides that the loss on the final disposition of a class of property may be charged against the income of the year of disposition.

RECOMMENDATION: That the definition of "disposition" be revised to make it clear that a taxpayer has the right to an allowance

for the undepreciated capital cost of property which he has disposed of but for which, because of its lack of value, he has received no consideration.

6. Regulations — Parts XI, XII & XIII

As these regulations have only been made public for a period of a few months and consequently their application in practice has not yet been tested to any material degree, it is not possible at this time to make a comprehensive study of their effect in operation. However, in addition to the observations already made on subsec. (4) of Reg. 1100, there do appear at this stage to be some points which may cause difficulty or give rise to inequitable treatment of taxpayers. For example, the following provisions will create needless inequity and hardship:

(a) *Regulation 1100(1)(b)*

It is assumed that the words "capital cost" in sub-para. (i) are intended to mean actual capital cost in respect of items acquired prior to the 1949 taxation year, because only this interpretation will result in treatment consistent with that accorded items acquired subsequent to the 1949 taxation year.

RECOMMENDATION: That the word "actual" be inserted before "capital cost" to avoid possible misrepresentation.

(b) *Schedule B, Class 13*

There are many instances in which expenditures which would come under class 13 of Sch. B have a useful life significantly less than the remaining period of the lease.

RECOMMENDATION: That greater flexibility be allowed in dealing with expenditures of this type.

(c) *Regulations 1300 and 1303*

Taxpayers filing T1 returns rarely know and have no way of ascertaining the proportion that the mineral profits bear to the income of the company from which they receive dividends which are eligible for deduction under Part XIII. In order to make this information available to the shareholders, so that they may determine accurately their tax liability, information will be required as to the applicable rate of depletion.

RECOMMENDATION: That a list of the rates that are applicable to the dividends from various companies be published before the date for filing returns.

(d) *Schedule B, Class 8*

Class 8 under Sch. B excludes certain items from the deductions in respect of capital cost, which formerly were included in determining taxable income. Item (a), an animal, results in the exclusion of the cost of horses used for business purposes which were formerly allowed at a 10% rate. However, if it is intended to allow a deduction in respect of such animals on an inventory basis taxpayers will be treated equitably.

RECOMMENDATION: That this question be clarified as soon as possible.

(e) *Schedule B, Class 8*

Also excluded under class 8 are railway track, railway grading, railway subway and a railway street crossing. A number of taxpayers, not in the business of railroading, have expended moneys upon assets of this nature. Expenditures by such taxpayers on assets of this type are necessary to the carrying on of their business and should be taken into account in determining the allowances deductible in determining taxable income.

RECOMMENDATION: That this regulation be amended accordingly.

II. Instances Where Capital Gains Are Taxed

The Act defines "income from business or property" in s. 4 to be "the profit therefrom for the year". Nowhere is it expressly stated in the statute that capital gains shall not be taxed. The *Income Tax Act* operates to tax what is named therein less the permitted deductions without precision as to their nature as between capital and income.

1. Section 8(1)(c)

This para. contains express power to tax any benefit or advantage which is conferred on a shareholder by a corporation and does not distinguish between benefits of a capital or benefits of an income nature. It is not limited by any words which state that these benefits shall only be taxable to the extent that they are included in income. Thus, s. 8(1)(c) can be employed in any fashion, even to tax capital transactions. There is no discretion in this section, no mitigation in the imposition of the tax. It is a charging

section apart from the other charging sections of the Act, which clearly and openly taxes capital transactions.

RECOMMENDATION: That s. 8(1)(c) be deleted from the statute. Benefits or advantages of an *income nature* are taxable under many other sections of the Act, notably ss. 3, 4, and 16. An additional para. to tax such benefits to a shareholder is unnecessary and redundant. If this para. is not repealed, it is recommended that it be limited to tax only those benefits to the extent that they are income in the hands of the recipient and thus eliminate the now accepted possibility that this para. will tax capital gains.

2. Section 125(2)

Section 125 subsec. (2) provides that where sales, exchanges, declarations of trust or other transactions of any kind result in one person conferring a benefit on a taxpayer, the benefit shall be taxable in one of three alternative methods. The benefit may be included in income, it may be treated as the income of a non-resident, or it may be treated as being a gift. This subsec., and indeed s. 125 in its entirety, nowhere states what type of benefit shall fall into what category of treatment. The same argument that was raised in connection with s. 8(1)(c) above applies with equal force to this subsection. Section 125(2) is a charging section separate from the rest of the Act and does not distinguish between income benefits and capital benefits but contains the power to include them all or any part of them as income or as gifts for purposes of taxation under the Act.

RECOMMENDATION: That s. 125 be repealed as being redundant or alternatively that subsec. (2) be so amended that benefits of an income nature be included in income while benefits of a capital nature be subject to gift tax only. In this manner, even if subsec. (2), which is wholly objectionable, is retained in the Act, the benefits which can be established to have arisen as a matter of fact thereunder, will be taxed properly in accordance with the other provisions of the Act according to whether they are capital or income.

3. Section 126

Section 126 is wholly objectionable from every aspect and it is submitted that it should be repealed forthwith. Under this particular heading of consideration, however, s. 126 is objectionable because it contains the open power to tax capital gains. Many instances have arisen where shareholders have sold or have asked a ruling in connection with the sale of shares in corporations which they may or may not control and which have large undistributed income on hand. The administration has informed such applicants that if the sale is consummated a reference to Treasury Board may be made with a view to imposing a tax on the profit realized by the seller of his shares. It is believed by the majority of taxpayers of this country that any man is entitled to dispose of capital assets without the uncertainty of attempted taxation. Section 126 is vicious in that it accords the executive the full power to tax capital gains.

RECOMMENDATION: That s. 126 be deleted from the Act.

4. Section 6(1)(g)

A further instance where the *Income Tax Act* imposes a tax upon capital in the hands of the owner is under the application of s. 6(1)(g) to what are known as "open end investment trusts". These organizations, to the extent that the funds subscribed may be returned to the shareholders, are forced to function somewhat differently under the prevailing company law than ordinary corporations. They are required to set aside out of the moneys subscribed for common stock a portion which is credited to capital surplus account and earmarked to be employed only for the so-called redemption of such common stock when a subscriber offers it to the company for sale. For example, an individual may subscribe $10 to such a trust and will receive therefor a common share whose par value is only, for example, $2: $2 is credited to capital stock account and all or part of the $8 differential is credited to capital surplus account. At some future time this or another shareholder presents his certificate for redemption to the company, wishing to terminate his investment therein. He receives back $10, the current operating earnings of the company having normally been paid out substantially in their entirety from year to year. Under s. 6(1)(g), however, quite apart from

s. 9(2), the shareholder has received a premium of $8 upon which he is required to pay tax. There would appear to be little possibility that para. (g) could be construed in any other fashion in view of the Income Tax Appeal Board decision in *Wharton* v. *M.N.R.* [1949] T.A.B.C. 93 under a very similar provision of the *Income War Tax Act.*

It is apparent from the facts recited that the incidence of tax in this case is not intentional. It is suggested, therefore, that an appropriate remedy would be to except from the application of s. 6(1)(g) all companies which qualify under s. 62 of the Act to the extent that what is received back does not exceed the price paid for the shares by the recipient either on the open market or to the corporation itself.

III. Unrealized and Unreal Benefits

There are a number of sections in the *Income Tax Act,* not present in the *Income War Tax Act,* which impose taxes on income not received in money or money's worth and not necessarily received or receivable in terms of economic enjoyment or benefit.

1. Sections 9, 16, 125 and 126

Under none of these sections must the Crown establish that the taxpayer has benefited in money's worth. Something which he may never receive or enjoy, such as the increases in equity behind share capital or the transformation of money in the hands of a corporation stranger to him, may give rise to a very severe tax penalty in his hands. The Government has already recognized this injustice in the case of capitalizations effected by non-resident corporations in respect of which Canadian taxpayers used to be taxable. It is submitted that this merely highlights the fact that the situation within Canada has not been repaired.

It is also submitted that, aside from the accrual basis of calculating income, income tax should be imposed only on those occasions when the person taxed receives money or money's worth in respect of the benefit taxed and by means of which the resultant tax liability can be satisfied. It is realized that the adoption of this principle or, rather, the reversion to this principle which has been hallowed in the British Courts and under the Canadian Act before the introduction of the *Income Tax Act,* might result in the loss of revenue to the Government in certain situations; such as, for example, where income is capitalized or converted into capital without the taxpayer receiving money's worth.

RECOMMENDATION: That there be included within the statute a general section stating that receipt in money or money's worth must be the prime test of whether or not a benefit can be taxable as income.

2. Section 13

Another instance of the effect of taxation upon real or unrealized benefits is the presence of s. 13 in the Act. Section 13 states that the income of a person for a taxation year shall be deemed to be not less than his income for the year from his chief source of income. This means that an individual's chief source of income once determined by law or fixed by the discretion of the Minister, as contained in subsec. (2) of that section, cannot be reduced by losses suffered in other aspects of his economic life. We thus have the spectacle of a man receiving *on paper* an income from his chief source and suffering *in fact* losses in other directions (not of a capital nature) being taxed upon the paper income from his chief source without any abatement, although he has never and will never receive it and has not got the funds out of which to pay the tax, e.g. non-professional farmers.

It is submitted that s. 13 is unnecessary and redundant since the definition of loss in the Act fully protects the revenue against any claim which may be made for the deduction of capital losses from income. Further, the use of the word "source" in s. 13 is objectionable and causes great hardship. It is felt that the taxing statute should return to the fundamental concept that what is to be taxed is a man's net income, i.e. the sum of his income from all sources less the expenditures and income losses applicable to that income from all sources. In this manner an individual and a corporation would be encouraged to develop in collateral lines, with the knowledge that if he failed income losses and income expenditures would be allowable

as set-offs against income in determining the aggregate net position for taxation purposes.

RECOMMENDATION: That s. 13 be deleted from the Act.

3. Stock Rights

A further example of the taxation of unreal and unrealized benefits is the taxation of rights to subscribe for shares in a publicly listed company where the market inevitably adjusts before the shareholder can realize or enjoy whatever benefits he was intended to have, so that he has on the day of receiving his stock rights, no more in terms of the overall equity interest in the corporation than he had the day before. This has already been the subject of numerous briefs and statistical evidence and it is beyond question that stock rights do not confer a net benefit upon a shareholder.

RECOMMENDATION: That there be included within the statute a general section stating that receipt in money or money's worth must be the prime test of whether or not a benefit can be taxable as income.

IV. Administrative Discretion

The *Income Tax Act* contains a number of provisions where administrative discretion is permitted to flourish as before the change in Government policy and the Courts are ignored as effective tribunals and even as to their already existing judgments. The most glaring examples of the remaining authority to exercise administrative discretion are ss. 9(6) and 126.

1. Section 9(6)

Under s. 9(6) it was pointed out to the Minister of Finance in the last joint submission of these Associations that no effective means of appeal existed. Under this section the Minister may notify a corporation that in his opinion the undistributed income exceeds what is reasonably required for the purpose of the business. This notice is sent to the corporation and not the shareholder. The shareholder, in most cases, is not aware that such a letter has been received by his corporation as is evidenced by the surprise evinced by the shareholders of certain public companies which were recently the recipients of such a letter and declared a dividend of large proportions to their shareholders as a result. The corporation must then establish that the undistributed income did not exceed what was reasonably required for its business or that the Minister had picked an unduly large figure in that connection. In order to do this effectively, the corporation would be required to appeal to the Exchequer Court but this is not permitted it. The corporation itself is never assessed, such assessment going to the shareholders some years after the event. Thus, the assessment is in fact, but not in law, directed to the corporation through the mailing of the letter, but the assessment from which appeals must be taken is directed to the shareholder. The passage of time is important in this connection, as was pointed out to the Minister in the spring, since subsec. (8) provides that if a letter has been received by a corporation and the actual money deemed to have been distributed is not actually distributed within ninety days from the date of the letter, any further distribution of these moneys will be taxable a second time in the hands of the shareholders. This means that a corporation receiving such a letter may undertake negotiations with the Department but cannot afford to impose a further liability upon its shareholders by failing to actually distribute the moneys in question within ninety days. The result is, in effect, that the corporation does distribute, the shareholder receives his money and any appeal from the Minister's letter is worthless since, even if it were successful, the shareholder would remain taxable as having received the moneys in question.

In addition, s. 115 is now being employed in connection with subsec. (6) of sec. 9, which is felt to be a misuse of the power contained in that section.

This is considered to be a denial of justice of the worst kind. It is, by a distortion of legislative intention, the deprivation of a shareholder of any effective means to dispute or even to discuss the liability imposed upon him by a discretionary act of the administration.

RECOMMENDATION: That s. 9(6) be deleted from the statute, or, alternatively, that a letter be directed to the company or the shareholder with full powers of appeal to all as is the case in every other distribution under the Act, and without any time

limit upon the time when the moneys may be paid out to him.

2. Section 126

Section 126 has already been mentioned as being objectionable for other reasons. It is even more objectionable for the reason that it vests in the authorities a discretionary power to determine when a taxable benefit arises even though that benefit may not be of an income nature and may never be received in money or money's worth. The effect of the decisions of the Courts which state that the onus is always upon the taxpayer to refute every argument in law or in fact which may be raised against him in effect deprives taxpayers assessed under these sections of any relief before the Courts. It is extremely difficult to refute by proof or by argument the opinion of an administrative official that a benefit has been received when the only question before the Courts is whether or not it should be affirmed or be vacated and referred back to be exercised again.

RECOMMENDATION: That s. 126 be repealed.

3. Depletion Allowance to Life Beneficiaries

A further example of the disregard for the Courts in the scheme of the taxation law in Canada is seen in the recently issued T.3 Return on page 2 whereof it is stated:

> "No deduction, however, is to be made for depletion if the income of the estate or trust is payable to a life beneficiary or life beneficiaries."

This completely denies the benefit accorded by the decision of the Exchequer Court of Canada in *Gilhooly* v. *M.N.R.*, [1945] C.T.C. 203. Further the publication of this form first publicly drew the attention of taxpayers to the fact that the right of a life tenant to depletion had been done away with.

RECOMMENDATION: That Part XIII of the regs. and s. 11(2) be amended to ensure to life tenants the depletion allowance granted to those receiving dividend income from oil and gas wells and mines.

4. Valuation of Inventory (s. 14(2) & Reg. 1800)

In s. 14(2) attempt is made to prescribe methods of inventory valuation for purposes of computing income. One method, namely the cost to the taxpayer or its market value whichever is lower, is specifically mentioned in the Act, and the door is left open so that further methods may be prescribed by regulation. Reg. 1800, recently published, adds two such methods, namely:

(i) All the property described in all the inventories of the taxpayer must be valued at its cost to the taxpayer; or

(ii) All the property described in all the inventories of the taxpayer must be valued at its fair market value.

Thus, there are now 3 different methods of inventory valuation permitted under the Act.

Owing to the varying circumstances of different businesses, many different methods of inventory valuation have been evolved and applied consistently to the businesses to which they are best suited. These methods, over the years, have been found to reflect income for the year in as satisfactory a manner as possible and have come to be regarded as sound commercial practice. A number of these methods, but by no means all, will fall within the scope of the methods now sanctioned under the Act.

Furthermore, there is considerable uncertainty as to the interpretation of the words used in the statute "cost to the taxpayer or its fair market value, whichever is lower", both as to the meanings of "cost" and "fair market value" and as to the method of application of the principle of "lower of cost or market". Only if the meanings attributed to these terms are those which they have in a commercial and accounting sense, will a vast number of taxpayers be entitled to continue following practices which they have been following consistently over a long period of years.

It is submitted that to legislate specifically for the many sound methods of inventory valuation used in business is an impossible task and that to attempt to do so can only result in forcing many taxpayers into methods of inventory valuation quite inappropriate to their trade or business. At the same time they will be obliged to abandon methods which they have followed consistently for many years, which have resulted in reflecting

fairly the annual income and which were acceptable under the *Income War Tax Act*.

Whilst affirming that an attempt to legislate specifically for methods of inventory valuation will result in inequitable treatment of taxpayers and in unwarranted interference with business, the importance of inventory valuation in determining profits and the consequent interest of the Revenue in the methods adopted are fully realized. In this regard it is submitted that adequate safeguards to the Revenue are contained in s. 4 of the Act, wherein income from a business is stated to be the profit therefrom. It is believed that there is an abundance of jurisprudence to ensure that in determining the profit from a business the inventory shall be valued on a consistent basis, in accordance with the custom of the trade and in accordance with sound accounting practice. Surely, if these principles are enforced, the rights of the Revenue are fully protected and there is no need whatsoever for specific legislation, which, as pointed out above, cannot prove equitable and which must be handicapped by lack of flexibility.

In this country, the *Income War Tax Act* contained no specific provisions relating to inventory valuation, yet the lack of marked dissatisfaction on the part of either the Revenue or the taxpayer is evidenced by the complete absence of case law on the subject. In Great Britain and other nations of the Commonwealth the tax statutes are tacit on the subject and no disadvantages either to the fiscus or to the taxpayer seem to have resulted therefrom. In short, there can be no justification whatever for introducing into a new statute, one of the avowed objects of which was to simplify the law, an unnecessary provision which by its nature will tend to make the law more and more complicated.

RECOMMENDATION: That s. 14(2) be deleted from the Act.

V. Cases of Discrimination

1. Income from Office or Employment (s. 5)

The income subject to tax should be the net income for the year, that is, the amount received by the taxpayer after payment of the expenses of earning it. There is no more reason for departing from this principle in the case of persons whose income consists of salary or wages than in the case of persons whose income is derived from business or property. Admittedly administrative convenience, which appears to be the explanation for the discrepancy in the treatment of salaried income, is entitled to consideration, but it is not the only consideration. The injustice of the present treatment is emphasized by the additional exceptions from it created by the recent statute in respect of certain classes of railway employees and clergymen. The incidence of taxation should be primarily governed by the principle of justice to the taxpayer rather than that of convenience to the tax collector. In other countries, notably Great Britain and the United States, whatever conflict there may be between these two considerations has been resolved more satisfactorily than in this country.

RECOMMENDATION: That the Act be amended to permit the deduction of expenses laid out for the purpose of gaining income from an office or employment.

2. Pensions (ss. 6(1)(a), 11(1)(g), and 34)

Under the present law all superannuation or pension benefits and retirement payments are chargeable as income in the year of receipt (s. 6(1)(a) and 34), but a special concession is granted to one group of citizens, viz., employed persons, who are exempted from taxation during their working years on their contributions to *approved* plans set up by their employers (s. 11(1)(g)). This concession is granted for sound reason, namely to enable employed persons to apply a portion of the income earned by them during their active years to their years of retirement and thus avoid becoming dependent on the charity of their relatives or the public.

The only reason for confining this privilege to this special group of employed persons is, obviously, not because the same policy is not equally desirable for others but because adequate safeguards have not been established to ensure that pension plans for others will be soundly administered and the funds used for the designed purpose. The question of safeguards aside, it is no less desirable that per-

sons other than this special group should make provision in their working years for their support on retirement. The substantial question is thus one of providing safeguards to prevent persons from using provisions designed to encourage an extension of pension plans as a means of tax avoidance or evasion.

Another unfortunate consequence of the existing law is that persons who make contributions to pension schemes other than approved plans are taxed twice on a part of their income, which must to some extent be an inhibitory influence against an admittedly desirable policy. They are allowed no deduction on their contributions to their scheme, and they are subject to tax on the pension payments when paid out years later, despite the fact that a portion of the payments is merely a return of their original contribution.

It is believed that considerable encouragement to pension schemes can be provided by a means which will leave no room for tax avoidance and will at the same time wipe out the present inequitable position in which non-approved pension plans are placed. These ends could be achieved by placing pension benefits from non-approved pension plans on the same basis as annuities, namely, exempt from tax the portion which is a return of savings.

At the same time, and independently of the above recommended policy, further consideration should be given to extending the present policy of allowing the deduction of contributions to approved pension plans and include persons, such as proprietors and partners. It is clear enough that an immediate tax benefit is more welcome than a postponed one, and if proper safeguards are created, the extension of the policy now set out in s. 11(1)(g) will do a great deal to encourage a very worthy objective, viz., the provision by citizens out of their earnings during their working years for their own support in retirement.

RECOMMENDATION: That pension benefits from non-approved pension plans be taxed on the same basis as annuities and that consideration be given to extending the scope of approved plans to include proprietors and partners.

3. Remuneration Paid to Spouse or Spouse of Partner (ss. 21(2) and (3))

Remuneration paid one spouse as an employee of the other or as an employee of a partnership in which the other spouse is a partner should be deductible where the employment is *bona fide*. Adequate protection against evasion is afforded by s. 12(2), which prohibits the deduction of expenses not reasonable in the circumstances.

RECOMMENDATION: That subsecs. 21(2) and (3) be repealed.

4. Consolidated Returns (s. 75)

Sound accounting and commercial practice requires the consolidation of the accounts of parent and subsidiary companies for the accurate reporting of income in many instances. This particularly applies where the situation is within the scope of subsec. (1) of this section. Furthermore, from the administration's point of view, consolidated returns simplify the administration of the Act by making it unnecessary to police intercompany transactions. Since the loss carryover provisions have now been extended to cover a period of seven years, the filing of returns on a consolidated basis is not likely to give any taxpayer an unwarranted advantage, and thus the additional tax of 2% operates as a penalty and a deterrent to a desirable practice.

RECOMMENDATION: That the 2% additional tax applicable to consolidated returns be removed.

5. Tax Payable by a Corporation (s. 36(3), (4), and (5))

To subject related companies to a higher rate of tax on their first $10,000 of income, while it may prevent some tax avoidance, at the same time introduces inequities particularly in cases where minority interests are involved. Furthermore, where two or more companies are related and no one company earns profits of $10,000 in a taxation year, the full benefit of the lower rate cannot be obtained.

Certainly to extend the lower rate of tax to all companies constituted before the announcement of the present policy by the Minister of Finance in March 1949 cannot give rise to tax avoidance. To extend the policy

to all companies, regardless of the date of incorporation, would have the advantage of removing the present inequities, and it is unlikely that it would result in any material loss to the Revenue.

RECOMMENDATION: That the lower rate of tax be extended to all companies without exception. If this is not considered possible, the benefit should be extended to all companies constituted prior to March 1949, and, in the case of related companies to which this extension would not apply, provision should be made to permit apportionment between companies of the first $10,000 of income subject to the lower rate of tax.

VI. Tax Evasion
Sections 125 and 126

The strongest objection is raised to the continued presence of these two provisions in the tax law now that the war and the post-war reconstruction period are over, and the times no longer call for the retention of extraordinary power by the Government. The time has now come to reinstate the ordinary law by which Canadian citizens and British subjects are wont to be governed.

We believe that in a true democracy such as Canada citizens should be free to do whatever is permitted by law, and that the freedom should not be hedged in and rendered dubious by the retention of shadowy and undefined powers by the Crown. Our ancestors struggled for centuries to limit and define the powers of the Crown, and to make them subject to the law, particularly in regard to taxation. If the law itself is now to be used as a means of restoring that arbitrary power, the struggle will have been won in vain, but the forces which won it centuries ago are still present in the character of the Canadian people and will operate with increasing vigour until the situation is restored.

Tax evasion is most reprehensible and should be prevented by every proper means. But what is tax evasion? The Courts have for many years sanctified the doctrine that a taxing statute must be strictly construed and that only Parliament can impose a tax, and even then requires the clearest of words to do so. In Great Britain Parliament has honoured this principle and has given not the slightest hint of even a predilection towards the viewpoint which in Canada manifests itself in ss. 125 and 126. We point to the recent House of Lords decision in *Commissioners of Inland Revenue* v. *Wesleyan & General Assurance Society* (1948) 30 T.C. 11, where the House of Lords reaffirms the basic principle as follows:

> "It may be well to repeat two propositions which are well established in the application of the law relating to Income Tax. First, the name given to a transaction by the parties concerned does not necessarily decide the nature of the transaction. To call a payment a loan if it is really an annuity does not assist the taxpayer, any more than to call an item a capital payment would prevent it from being regarded as an income payment if that is its true nature. The question always is what is the real character of the payment, not what the parties call it.
>
> Secondly, a transaction which, on its true construction, is of a kind that would escape tax, is not taxable on the ground that the same result could be brought about by a transaction in another form which would attract tax. As the Master of the Rolls said in the present case (page 16 *ante*) 'In dealing with income tax questions it frequently happens that there are two methods at least of achieving a particular financial result. If the other method is adopted, tax will not be payable . . . The net result from the financial point of view is precisely the same in each case, but one method of achieving it attracts tax and the other method does not. There have been cases in the past where what has been called the substance of the transaction has been thought to enable the Court to construe a document in such a way as to attract tax. That particular doctrine of substance as distinct from form was, I hope, finally exploded by the decision of the House of Lords in the case of *Duke* of *Westminster* v. *Commissioners of Inland Revenue*, 19 T.C. 490.'"

We would also refer you to the countering measure which the British Parliament took to prevent the device from being used in the future. See *Finance Act, 1949*, s. 25, enacted 30th July, 1949. This provision is ex-

pressed in the most precise language, and is specifically given prospective operation only.

Encouragement and support will be wholeheartedly given to any legislation which Parliament may enact to deal with specific instances of tax evasion. But Canadian citizens should certainly be entitled to believe and to act upon the belief that conduct which is not forbidden by law will not be penalized under either *ex post facto* legislation or by the exercise of arbitrary power by the Crown.

RECOMMENDATION: That ss. 125 and 126 of the Act be repealed.

VII. Memo Re Trusts Administered in Canada

With Reference to Exemption from Tax of Income from Outside Sources Passing Through a Canadian Trust and Going to a Non-resident Beneficiary

Two situations arise in this connection:

1. The first situation involves the receipt of income from United States sources by a Canadian trustee who disburses such income back to beneficiaries who are residents of the United States. This situation under recent rulings of the Canadian tax authorities results in double taxation since in Canada the income passing through the Canadian trust is being taxed here, while the United States also taxes it upon receipt by the United States beneficiary. At the present time neither the existing Convention between the two countries nor the regulations alleviate this hardship. On the other hand income from Canadian sources paid to a United States trustee and then remitted to a Canadian resident beneficiary is free of United States tax. It would seem reasonable that the situation in Canada should be corrected by any supplementary convention that is entered into between the two countries.

If the supplementary convention contained the following provision it would alleviate the situation:

> "Income which is derived from sources within one of the contracting states by an estate or trust resident in the other contracting state and distributed or distributable to any beneficiary of such estate or trust who is a resident of the former state shall be exempt from tax in the latter state."

2. The second situation involves dividends and interest received by shareholders of a Canadian corporation which receives part of its income from United States sources. This situation is presently covered by Article XII of the existing Convention between Canada and the United States.

Under the United States income tax laws, dividends paid by a foreign (as to the United States) corporation constitute in part, at least, income from United States sources if 50% or more of the gross income of the foreign corporation for the three taxable years preceding the declaration of the dividend was derived from sources within the United States. The United States laws also provide that in the case of interest paid by a Canadian corporation, the entire amount is deemed to be from United States sources if the foreign corporation is a "resident" of the United States and derives at least 20% of its income from United States sources. This situation might also be covered in an amendment to Article XII.

It would be appropriate that approximately the same broad exemption which is presently granted by the United States-United Kingdom Convention be also provided for in any supplementary Canada-United States Convention. Such a provision as the following would cover the situation:

> "Dividends and interest paid on or after the effective date of this Convention by a corporation organized under the laws of Canada shall not constitute income from sources within the United States and shall be exempt from United States tax, except where the recipient is a citizen of or a resident of the United States or a United States corporation."

If the above was done, Canadian corporations deriving any income whatsoever from the United States would benefit because of the effect on investments in Canadian corporations.

VIII. General Recommendations

1. Double Taxation of Corporation Income and Accumulated Surpluses of Closely Held Companies

An essential to the growth of the Canadian economy is a tax policy which will produce

the needed revenue without discouraging enterprise. A principal objection to the present income tax structure is the double taxation of corporation income, with its resultant discouragement to enterprise.

The desirability of solving this problem is recognized by the Government. It was thus with general approval that the community received the announcement of the Minister of Finance on 22nd March 1949 in which he introduced the "first step" of reform designed to bring about the removal of double taxation of corporation income. It is hoped that the succeeding steps in the policy will be enacted as soon as possible.

Furthermore, solution of this problem will have the concomitant effect of preventing the recurrence of the vexatious problems arising from the accumulation of earnings in the hands of closely held corporations. These problems are again acute, even though relief was granted in 1945 under the provisions of Part XVIII of the *Income War Tax Act*, but as was pointed out by the Minister of Finance on March 22, 1949, "So severe is the application of our present law in such cases that many businesses have been driven into a great variety of extremely complicated and cumbersome devices to secure legal avoidance of the excessive tax burden to which they are now potentially liable."

If the policy dealing with the whole problem of double taxation of corporate income has been designed to take care of prior accumulations of earnings by closely held companies, the acuteness of the present situation makes it even more desirable that the remaining steps in the policy be undertaken at once. If the policy does not cope with this problem of accumulated earnings, then it is recommended that special provision be made to relieve this excessive liability.

2. Interest on Borrowed Money (s. 11(1)(c))

The recent decision of the Supreme Court of Canada in *T. E. McCool Ltd.* v. *MNR* [1949] C.T.C. 395 that interest owing upon the purchase price of a property used in the business is not deductible as an expense is at variance with ordinary commercial usage as well as with the practice which prevailed under the *Income War Tax Act*.

RECOMMENDATION: That s. 11(1)(c) be amended to counter the effect of the recent decision in the McCool case.

3. Reserves (s. 12(1)(e))

In order to arrive at the proper figure for the profit of any enterprise provision must be made for losses on current transactions which experience has established will be incurred in the future. Clearly the profit on a series of transactions which takes no account of rebates or losses which, though not yet incurred, will certainly be incurred, is inaccurate, and if the tax law takes no account of this undoubted error the taxpayer suffers an excessive tax burden which can in some cases be serious since the loss carry-over will not absorb every loss. If the law is changed as recommended below, reserves existing immediately before the change might be allowed in the year following or otherwise spread over a short period of years.

RECOMMENDATION: That reserves should be permitted to provide for costs and expenses which are an ordinary risk of business already transacted and which would be deductible as an expense if incurred in the taxation period, e.g., a reserve for obligations to repair or replace products already sold (warranties or guaranties). These should be permitted to the extent that experience has shown them to be reasonable and proper.

4. Limitation on Interest Period (s. 50(6))

The reduction in the period during which interest is payable on arrears of taxes from 20 months to 12 months is most welcome, evidencing as it does the intention, which is being borne out in practice, of making assessments promptly. Section 50(6) also provides that interest shall again become payable on the arrears "30 days from the day of mailing of the notice of the original assessment for the taxation year". The use of the word "original" in this phrase may, however, nullify the entire advantage gained from the earlier portion of the subsection, if the "notice of original assessment" is held to be the notice which, in this past year, has been issued by the Taxation Division within a few weeks of the receipt of individual returns. If this receipt notice is a notice of original assessment

within the meaning of s. 50(6) the whole object of the section disappears, and it is clear that such was not the intention of Parliament in reducing the interest period from 20 to 12 months.

RECOMMENDATION: That the word "original" be deleted in the phrase "notice of the original assessment" and the phrase be amended to read "30 days from the day of mailing of the last notice of assessment".

5. Personal Corporations — Penalty (s. 61(7))

The penalty which may be imposed on the principal shareholder of a personal corporation for failure to file financial statements of the corporation with his tax return is extremely harsh and, moreover, is unnecessary since there is elsewhere in the Act a severe penalty for the non-disclosure of investment income which would meet the case.

RECOMMENDATION: That the penalty provision be deleted from s. 61(7) or reduced to a nominal amount.

6. Penalty for Failure to File Information Returns (s. 117)

The penalty imposed by s. 117 for failure to file information returns under s. 106 and s. 112(2) is unnecessarily severe in the case of the returns required by the latter provision. Section 112(2) requires every employed person whose employer is required to deduct tax from his remuneration under s. 44 to file a prescribed return of his marital status and dependents' allowances. If he fails to file such return he will be subject to a tax deduction at the source as an unmarried person without dependents, i.e., at the highest rate. Obviously, therefore, his failure to file the prescribed return carries with it its own penalty, which will be sufficient to ensure that the duty is performed. The only person who suffers from the failure is the taxpayer, certainly not the Revenue, which actually benefits from the failure. It seems apparent that the reference to s. 112(2) was inserted by error in s. 117.

RECOMMENDATION: That s. 117 be amended by deleting the reference to s. 112(2).

7. Undistributed Income (s. 127)

It is recommended that a definition of undistributed income be enacted in the language employed in s. 94 of the *Income War Tax Act*, subject to two small changes:

(i) Presumptive dividends as well as actual dividends should be deducted in computing undistributed income (see s. 20 of the *Income War Tax Act*).

(ii) An income derived from fiscal periods ending prior to 1st July 1917 should be excluded from the computation, inasmuch as the *Income War Tax Act* was not applied to periods prior to that time.

March 13, 1950

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

IT may seem like splitting hairs at first, but there is really a basic difference in the accounting philosophy of those who say that assets minus liabilities equal proprietorship and those who hold instead that assets equal liabilities plus proprietorship. It is more than a matter of transposing an equation. It is, as a matter of fact, an argument of long standing and one which found two of the most distinguished accountants of recent times on opposite sides of the fence.

Henry Rand Hatfield took what has been called the "proprietary" view of accounting theory. In essence this theory said that the purpose of accounting was to account for changes in proprietorship. It meant that proprietorship should have one side of the balance sheet equation all to itself, viz., assets — liabilities = proprietorship. The genius of double entry bookkeeping from this point of view is that at the same time it is recording the changes in assets and liabilities which result from business transactions it is also recording the concurrent changes, if any, in proprietorship.

In our opinion this approach has much to be said for it both from the point of view of the historical development of double entry bookkeeping and from the point of view of the student approaching double entry for the first time. While they may no longer be the most important forms of business organization, double entry theory was originally developed to meet the accounting requirements of the single proprietorship and partnership. We think that the single proprietorship must still be the most convenient vehicle for introducing bookkeeping theory to the newcomer.

It is interesting to observe that some of the recent attempts at overhauling the balance sheet to make it more readable involve an implicit acceptance of the theory held by Hatfield. The now-famous balance sheet form used by the Caterpillar Tractor Co., for example, deducts liabilities from assets to arrive at a figure for proprietorship, and the composition of proprietorship is then explained in an accompanying schedule.

* * *

On the other hand, applying the "proprietary" (or "proprietorship") theory to the extremely important case of the modern corporation is not all clear sailing. It remained for W. A. Paton to emphasize that the difference between liabilities and proprietorship, particularly as it relates to a limited company, is only one of degree. It is not realistic to say that the creditors, as distinguished from the owners, have no interest in the assets of the concern especially where limited liability is a factor. In any event there are certainly some kinds of bonds (income bonds, for example) that are not much different from shares.

To Professor Paton all the items conventionally shown on the right hand side of a balance sheet (that is, both liabili-

ties and proprietorship) are tarred with the same brush. He prefers to head this side of the balance sheet "Equities". It is of course not possible to say that any one asset on the left hand side of a balance sheet belongs exclusively to any one class of creditor or owner listed on the other side — at any rate as long as the concern remains a *going* concern. It is still true to say, however, that the creditors and owners alike have an interest or "equity" in the total assets. This accounting philosophy adds up therefore to the equation, properties = equities (where properties are equal to assets and equities represent both liabilities and proprietorship).

In his *Accounting Theory*, published in 1922, Paton writes, ". . . the *total* of the equities at a given date is essentially determined by the *total* of the properties on the same date. To put the matter in its logical sequence it might be said that the accountant first determines the kind and amount of each asset and takes the total of the properties; he then apportions *this same total* among the various individuals and interests involved in accordance with what appears to be the legal rights and privileges of each equity" (p. 45). A little later in *Accounting Theory* he puts it this way, "But it cannot be stated too emphatically that every equity, proprietary or otherwise, furnishes capital (money, commodities or services); every equity involves risk of loss; virtually all equities have some privileges and responsibilities with respect to management; and all long-term equities have rights in income and capital" (p. 61).

To Paton the preoccupation with proprietorship as such has had unfortunate repercussions on the statement of profit and loss (or "income sheet" as he prefers to call it). In the same book he says, "The commonly accepted conceptions of the operating accounts advanced by the proponents of proprietary accounting have tended to shut the door to all discriminating analysis of the income sheet. As a result the average income sheet is a hodge-podge of illogical, non-illuminating classifications. . . . The income sheet of the large corporation, certainly, is not an adjunct of any single interest or equity in the balance sheet to be defined in terms of that interest; and any attempt to view it so results in distortion of so serious a character as largely to destroy the utility of that statement" (p. 53).

* * *

It is perhaps worth adding as a postscript to these already extensive *notes* that neither Hatfield nor Paton actually originated his particular philosophy of accounting but because each of them was an especially lucid writer they did succeed in making the issue much clearer than it had been before. In his delightful book *Accounting Evolution to 1900* Professor A. C. Littleton traces the development of the two opposing theories in the latter part of the nineteenth century. He calls them the "proprietorship" and "entity" theories respectively.

The two philosophies are certainly at odds when it comes to deciding what the nature of an expense is. By the proprietorship theory (assets — liabilities = proprietorship) an expense is a negative item of proprietorship. There is nothing incongruous in charging expenses entirely against the proprietor. On the other hand if the difference between liabilities and proprietorship is only one of degree (which is the crux of the entity theory), it is no longer possible to charge an expense exclusively against any one class of equity. It is incurred on behalf of all those with equities in the business, both creditors and owners.

Professor Littleton puts it this way: "In a sense this conception [the entity theory] tends to place 'assets' upon the

plane of 'expenses' by regarding the former as productive outlays awaiting appropriation rather than as objects intended for liquidation sale to satisfy creditors. The only difference between asset and expense is one of time of appropriation or association with specific units of income. . . . This theory also definitely gives a greater emphasis to 'costing' than to balance sheets; the intention is to associate cost and return, effort and effect" (pp. 201-202). It is probable, therefore, that the well-known contributions of W. A. Paton to the cause of income measurement may be traced to the fact that he has consistently espoused the so-called "entity theory".

PUZZLE

In a very hotly fought battle 70% at least of the combatants lost an eye, 75% at least lost an ear, 80% at least lost an arm, 85% at least lost a leg. How many at least must have lost all four?
(From: Lewis Carroll, *A Tangled Tale*, 1881, cited by Yule and Kendall in *An Introduction to the Theory of Statistics*, p. 24)

Note: The solution we propose to submit next month does not involve the use of statistical techniques.

SOLUTION TO LAST MONTH'S PUZZLE

The divisor contains three figures.

When multiplied by 7 the product consists of three figures also,

Therefore the first figure in the divisor must be 1.

When the divisor is multiplied by the first figure in the quotient, the product runs into four figures,

Therefore the first figure in the quotient must be greater than 7.

Similarly the last figure in the quotient must be greater than 7.

The fourth figure in the quotient must be 0 since two figures must be carried down from the dividend before the divisor will divide into the result.

Carrying on from here the solution becomes,

```
                  97809
      124 ) ------------
            12128316
            1116
            ----
              968
              868
              ---
             1003
              992
             ----
                1116
                1116
                ----
```

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1949

Accounting I, Question 5 (10 marks)

Describe three methods of calculating depreciation and contrast their effect on reported profits over the life of the assets depreciated.

A SOLUTION

1. **Straight line method:** In this method the annual charge for depreciation is computed by dividing the total depreciation to be provided by the estimated number of years of service life of the asset. Where this method is used, the same charge is made against profits during each year of the life of the asset.
2. **Diminishing balance method:** In this method the annual charge is computed as a constant proportion of the net carrying value of the asset. Where this method is used, depreciation charges are high in the first years of the life of the asset, and decrease each year. It is assumed that repairs expense may increase as depreciation decreases, so that the total charged each year in respect of the asset will remain fairly constant.
3. **Production or use method:** In this method the annual charge is computed as that proportion of the total depreciation to be provided over the life of the asset that the production or use during the year bears to the total estimated production or use to be obtained from the asset. In this way, the charge to profit for each year bears a constant ratio to the production for the year.
4. **Sinking fund method:** In this method the annual charge is computed as that amount which, when invested at a certain rate of interest, will, together with the interest thereon, accumulate to the total depreciation to be provided for. Where this method is used the money must be actually invested in a sinking fund. Under this method, depreciation charges increase from year to year, as the interest increases.
5. **Annuity method:** This method is based on the assumption that interest on the investment in the asset should be included as an element of cost. The annual charge is determined as the annuity, calculated at a specified rate of interest, which will provide for the difference between the cost and the estimated salvage value in addition to providing for interest on the carrying value of the asset each year. The result is that the total charges to expense over the life of the asset exceed the depreciation to be provided by the sum of the amounts regarded as interest revenue.

Editor's Note: We suggest that the effect of each method of depreciation on profits might be illustrated by means of a graph, with time (to represent the life of the asset) plotted along the horizontal axis and profits in dollars plotted on the vertical axis. The graph for the straight line method would then show a straight line parallel to the horizontal axis; for the diminishing balance method, a curve sloping sharply upwards; for the production or use method, a line sloping upwards assuming a diminishing use of the asset over time (or vice versa); for the sinking fund method, a line sloping gently downwards; and for the annuity method a line identical with that for the sinking fund method.

PROBLEM 2

Intermediate Examination, October 1949

Accounting I, Question 6 (13 marks)

A, B and C entered into partnership on 1 Jan 1947. A did not contribute any capital. B invested $11,250 and C, $7,500. On 30 Jun 1947, more cash was required and A loaned the firm $9,000 at 5% interest per annum. The trading results, before interest, were:

For year ended 31 Dec 1947 — $6,225 profit.
For year ended 31 Dec 1948 — $3,000 profit.

Over the two years, each partner drew $1,200. On 31 Dec 1948, B died, and it was decided to dissolve the partnership.

Total assets realized $30,000.

Liabilities, not including interest for 1948, amounted to $2,325.

Required:

(a) Trial balance of the accounts of the partnership immediately prior to dissolution.
(b) Journal entries to record the dissolution of the partnership.

A SOLUTION

(a)

A, B, & C

STATEMENT OF PARTNERS' BALANCES
for the two years ended 31 Dec. 1948

	Current Account A	Capital Account B	Capital Account C	Total
Balances 1 Jan 1947	.....	$11,250	$ 7,500	$18,750
Add Interest 30 Jun 1947 to 31 Dec 1948, 5% on $9,000 for 1½ years	675			675
Profits for two years ended 31 Dec 1948 after interest	2,850	2,850	2,850	8,550
	3,525	2,850	2,850	9,225
	3,525	14,100	10,350	27,975
Deduct Drawings — two years	1,200	1,200	1,200	3,600
Balances, 31 Dec 1948	$2,325	$12,900	$ 9,150	$24,375

A, B AND C

TRIAL BALANCE AT 31 DEC 1948

A — Current account		$ 2,325
B — Capital		12,900
C — Capital		9,150
A — Loan		9,000
Assets	$35,700	
Liabilities		2,325
	$35,700	$35,700

(b) Closing Entries:

1. Profit and Loss	$ 5,700	
Assets		$ 5,700
Loss on realization of assets.		

2. A — Current account	$ 1,900	
B — Capital	1,900	
C — Capital	1,900	
Profit and Loss		5,700
Distribute loss on realization of assets.		

3. Liabilities	$ 2,325	
A — Loan	9,000	
Assets		11,325
Pay off liabilities.		

4. A — Current account	$ 425	
B — Capital	11,000	
C — Capital	7,250	
Assets		18,675
Distribute assets.		

PROBLEM 3

Final Examination, October 1949

Accounting I, Question 1 (20 marks)

Jane's Bros. Ltd., a company engaged in the manufacture of a standard product, has entered into negotiations with Mr. N. Vestor with a view to obtaining from him financial assistance. The company has no security to offer other than its working assets, and has provided Mr. Vestor with financial statements as at 31 Dec 1947, prepared by its chief accountant. These statements in themselves appear favourable but Mr. Vestor, before coming to a decision, asks a chartered accountant to make a brief investigation of the company's affairs and arranges for him to be given access to the necessary records.

The investigation discloses that there have been no substantial changes in the sales price of the company's product during the past five years nor have there been any considerable fluctuations in the price of material or labour during that period. Stocks of work-in-progress and finished products on hand are at all times so small as to be almost negligible because the process employed is very rapid and finished goods are sold and shipped immediately they are completed.

The following figures are obtained:

Year	Sales	Purchases of Materials	Direct Labour	Total Fixed Expenses	Total Variable Expenses	Closing Inventory Materials
1942						$34,050
1943	$203,200	$34,000	$46,000	$54,000	$50,800	24,000
1944	310,000	67,100	69,000	54,000	77,500	23,500
1945	315,000	79,200	70,000	54,000	78,850	34,000
1946	360,000	58,500	68,000	54,000	90,000	41,000
1947	410,000	79,900	73,000	54,000	102,500	80,000

Required:

Write a letter to Mr. Vestor incorporating such analysis of these figures and comments thereon as should be of assistance to him in making his decision.

A SOLUTION

2100 Perfect Bldg.,
Vancouver, B.C.

Mr. N. Vestor,
1800 Model Bldg.,
Vancouver, B.C.
Dear Mr. Vestor,

In accordance with the terms of our engagement we have now completed an investigation of the affairs of Jane's Bros. Ltd. We list below points which have emerged in the course of our examination and which we think are of significance for your purposes.

1. Since the company has only its working assets to offer as security, your chief security lies in continued profitable operations. An analysis of the operations for the past 5 years follows:

JANE'S BROS. LIMITED

SUMMARY OF OPERATIONS

	1943	1944	1945	1946	1947
Sales	$203,200	$310,000	$315,000	$360,000	$410,000
Opening Inventory	$ 34,050	$ 24,000	$ 23,500	$ 34,000	$ 41,000
Purchases	34,000	67,100	79,200	58,500	79,900
	68,050	91,100	102,700	92,500	120,900
Closing Inventory	24,000	23,500	34,000	41,000	80,000
Material Cost	44,050	67,600	68,700	51,500	40,900
%	21.7%	21.8%	21.8%	14.3%	10.0%
Direct Labour	46,000	69,000	70,000	68,000	73,000
%	22.6%	22.3%	22.2%	18.9%	17.8%
Prime Cost	90,050	136,600	138,700	119,500	113,900
Gross margin over prime cost	113,150	173,400	176,300	240,500	296,100
%	55.6%	55.9%	56.0%	66.8%	72.2%
Operating Expenses:					
Fixed	54,000	54,000	54,000	54,000	54,000
Variable—25% sales	50,800	77,500	78,850	90,000	102,500
Net Operating Profit	$ 8,350	$ 41,900	$ 43,450	$ 96,500	$139,600
% to Sales	4.11%	13.51%	13.79%	26.81%	34.0%

2. Since there have been no substantial changes in the sales price of the company's product during the years, nor any considerable fluctuations in the cost of labour or material during that period, it would appear that the percentage of gross profit and of cost of materials should remain fairly steady. Gross profit has increased somewhat, but material cost has fallen significantly in 1946 and 1947. This may mean that there is an attempt at "window dressing" and inventories are being overstated.

3. Based upon the percentage of material cost to sales as shown in years 1943, 1944 and 1945, it might be expected that the inventories at the end of 1946 and 1947 could be calculated as follows:

	1946	1947
Sales	$360,000	$410,000
Opening Inventory	$ 34,000	$ 14,020
Purchases	58,500	79,900
	$ 92,500	$ 93,920
less material cost of sales estimated as 21.8% of sales:	78,480	89,380
Estimated closing inventory	$ 14,020	$ 4,540
Closing inventory per books:	41,000	80,000
Apparent overstatement of inventory	$ 26,980	$ 75,460

4. Because there is no information given to indicate any change in the basis of inventory valuation, it may be assumed that no such change has taken place. It would therefore appear that the quantities of inventory may be overstated. A supervised physical inventory should be taken and the purchases and material used since the end of 1947 reconciled to the amount of goods shown.
5. Assuming the estimated inventories prove to be approximately correct, the operations for the years 1943-1947 could be summarized as follows:

	1943	1944	1945	1946	1947
Sales	$203,200	$310,000	$315,000	$360,000	$410,000
Prime cost of goods sold	90,050	136,600	138,700	146,480	162,380
Gross margin over prime cost	$113,150	$173,400	$176,300	$213,520	$247,620
% to sales	55.6%	55.9%	56.0%	59.3%	60.4%
Fixed expenses	54,000	54,000	54,000	54,000	54,000
Variable expenses	50,800	77,500	78,850	90,000	102,500
Net Operating Profit	$ 8,350	$ 41,900	$ 43,450	$ 69,520	$ 91,120
% to sales	4.11%	13.51%	13.79%	19.31%	22.2%

6. Assuming gross margin over prime cost of 60% of sales price is maintained, the breakeven point may be calculated as:

$$\frac{\text{Total Fixed Costs}}{\text{Margin over prime cost less variable expense}} = \frac{54{,}000}{.60 - .25} = \frac{54{,}000}{.35}$$

or $154,285. Sales must therefore not be allowed to fall below this figure, and labour and material costs must be held in line so that the gross margin over prime cost increases sufficiently above 60% to compensate for the decreased volume, or losses will be sustained. The average net profit over the five years as a % of sales, on the basis of the adjusted figures is approximately 16%. In order to sustain such a net profit ratio, assuming the continuance of the present sales to prime cost ratio, sales must not fall below $284,000.

Yours very truly,

SMART & WISE,
Chartered Accountants

PROBLEM 4

Final Examination, October 1949

Accounting I, Question 2 (10 marks)

Upon the completion of the audit of the STU Co. Ltd., the auditor submitted to the management and directors, in addition to the usual balance sheet and statement of profit and loss and surplus, the following statement of source and application of funds:

STU CO. LTD.

STATEMENT OF SOURCE AND APPLICATION OF FUNDS

for year ending 30 Sept 1949

Funds were derived from:			
Net profit for the year		$351,600	
Add charges not involving reduction of funds:			
Depreciation	$ 62,900		
Amortization of leasehold	6,100		
		69,000	
			$420,600
Sales of investments			134,000
Total funds derived			$554,600
Funds were applied as follows:			
Buildings and equipment purchased		$509,100	
Preferred shares retired, 1,120 @ $105		117,600	
Bonds redeemed, 2,900 @ $102		295,800	
Dividends preferred 6%		180,000	
common 5%		140,000	
			1,242,500
Net decrease in working capital			$ 687,900

Made up as follows:

	30 Sept. 1948	30 Sept. 1949	Working Capital *Increased*	Working Capital *Decreased*
Cash on hand and in bank	$ 126,700	$ 97,000		$ 29,700
Accounts receivable	513,000	521,000	$8,000	
Inventories	1,176,000	782,000		394,000
	$1,815,700	$1,400,000	$8,000	$ 423,700
Less accounts and notes payable	800,000	1,072,200		272,200
Working Capital	$1,015,700	$ 327,800	$8,000	$ 695,900
				8,000
Net Decrease in Working Capital				$ 687,900

Required

State why the auditor would include this statement, and explain what the study of the statement should convey to the management and directors of the STU Co. Ltd.

A SOLUTION

The auditor would include this statement to make more readily available an analysis from the potential information included in the financial statements, particularly because during the year the working capital has decreased materially. In 1948, the ratio of current assets to current liabilities was 2.27:1; in 1949 it dropped to 1.3:1. This decrease should be brought to the attention of the management and directors, and in order to help the executive to correct the situation, the auditor has analyzed and set out in this statement the reasons for the change. The statement summarizes changes in the working capital between the two balance sheet dates. It shows how funds received were applied and so helps to point up any excess expenditure of current funds.

The study of the statement should convey to the management and directors that:

1. Over 80% of earnings were paid out in dividends and in addition preferred shares and bonds were retired and fixed assets purchased. Investments (apparently long-term) have been sold to produce some of the required funds and working capital has also been seriously depleted.
2. Inventories have been materially decreased, and yet current liabilities have increased. Usually, reduction of inventories should result in reduction of current liabilities; possibly these liabilities may be for fixed assets purchased or may include dividends payable.
3. The company has attempted to retire its long-term indebtedness out of operations, and at the same time add to the fixed assets and continue to pay dividends. This has resulted in a weakening of the working capital position. It will be necessary to watch future expenditures closely in order to retain and improve the present current position.

Professional Notes

BRITISH COLUMBIA

Messrs. Campbell, Imrie & Shankland, Chartered Accountants, announce the appointment of Mr. A. J. Park, C.A. as resident manager of their Vernon office.

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Mr. R. W. C. Hopkins, C.A. announces the removal of his offices to Rm. 1624, Marine Bldg., 355 Burrard St., Vancouver.

ONTARIO

O'Sullivan, Fenny & Co., Chartered Accountants, announce that the partnership of Messrs. Frank W. O'Sullivan and W. G. Fenny has been dissolved. Mr. O'Sullivan will continue the practice of his profession under the name of F. W. Sullivan, C.A., with offices at 159 Bay St., Toronto.

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W. W. Pollock & Co., Chartered Accountants, announce the removal of their offices to the Ontario Bldg., 93 Ontario St., St. Catharines.

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Henry Barber, Mapp & Mapp, Chartered Accountants, 112 Yonge St., Toronto, announce the admission to partnership of Mr. Douglas M. Haig, C.A.

NOVA SCOTIA

Messrs. C. W. Gurnham, C.A. and W. J. F. Hanright, C.A. announce that they will carry on the former practice of Archibald, Gurnham & Co., Chartered Accountants, under the new firm name of Archibald, Gurnham & Hanright, Chartered Accountants, with offices at 138 Roy Bldg., Halifax.

QUEBEC

Mr. Max N. Padber, B.Com., C.A. announces the removal of his offices to Ste. 105, 354 St. Catherine St. E., Montreal.